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Sustainability-Linked Loans Series, Part 3 – The SLLP Core Components in Detail


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In our June edition of *REF News and Views*, we further explored the growing field of sustainability-linked loans ("SLLs") by introducing and outlining the Sustainability-Linked Loan Principles ("SLLP") and the SLLP core components ("Core Components").

As a reminder, 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. 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.

Further, the SLLP also set out a framework, enabling all market participants to clearly understand the characteristics of an SLL. The framework is based around the five Core Components, namely:

1. selection of key performance indicators ("KPIs");
2. calibration of sustainability performance targets ("SPTs");
3. loan characteristics;
4. reporting progress against SPTs; and
5. verification.

In this Part 3 of our series, we will focus on (1) selection of KPIs and (2) calibration of SPTs of the Core Components (and, in next month's edition of *REF News and Views*, we will dive deeper into (3) loan characteristics, (4) reporting progress against SPTs, and (5) verification).

Selection of KPIs

An SLL can be made to any company that has a sustainability strategy and can be any type of loan instrument and/or contingent facility (for example, bonding line, guarantee line, or letter of credit) where there is an economic impact tied to the borrower's achievement (or failure) of predetermined SPTs. The SLL will look to reward the company for achieving the goals set out in that sustainability strategy so long as the KPIs are meaningful for the company's business and the SPTs are sufficiently ambitious.

The KPIs are the cornerstone upon which the SLL market is based. The credibility of the SLL market essentially rests on the selection of the KPIs, and KPIs that are not credible should be avoided.

As recommended by the SLLPs, 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;
- measurable or quantifiable on a consistent methodological basis; and
- capable of being benchmarked, as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition.

The SLLPs recommend that a clear definition of each KPI should be provided, which should:

- include the applicable scope or parameters;
- include the calculation methodology;
- include a definition of a baseline; and
- be benchmarked against an industry standard where feasible (such as regulatory standards, from goals and objectives set in international agreements such as the Paris Agreement or the Sustainable Development Goals).

Helpfully, 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) that borrowers can consider when structuring their KPIs and ambitious SPTs. Examples include:

- Energy efficiency: Improvements in the energy efficiency rating of buildings and/or machinery owned or leased by the borrower.
- Affordable housing: Increases in the number of affordable housing units developed by the borrower.
- Employee engagement, diversity and inclusion: Improvement in specific long-term goals relating to improvements in diversity and training and further education.

For more examples, please see this link.

Calibration of SPTs

The process for calibration of the SPTs in respect of each KPI is key to the structuring of SLLs and is perhaps more important than even the selection of the KPIs. The reason is that the SPTs are key to driving behaviours and are designed to act as an expression of the level of ambition to which the borrower is willing to commit.

The SLLP states that the SPTs should be set in good faith and should remain relevant (as long as they apply) throughout the life of the loan. The SPTs should also be ambitious – namely, that:

- they represent a material improvement and go beyond a "business as usual trajectory";
- where possible, be compared to a benchmark or external reference;
- they are consistent with the borrower's overall sustainability/environmental, social and governance ("ESG") strategy; and
- they are determined on a predefined timeline, set before or concurrently with the origination of the loan.

The SPTs selected by the borrower should be based on recent performance levels and be based on a combination of benchmarking approaches. The SLLPs recommend that such approaches include:

- the borrower's own performance over time as measured against the selected KPIs – the SLLP recommends a minimum period of three years;
- the borrower's peers – the relative positioning of the SPT against its peers where available (including average performance and best in class performance) or against industry or sector standards; and/or
- references to science – such as science-based scenarios, absolute levels or official country/regional/international targets, or to recognised best-available-technologies or other proxies to determine relevant targets across ESG themes.

All disclosures on target setting should clearly refer to (i) timelines for target achievement, (ii) baseline reference points, (iii) when recalculations will happen, (iv) how the borrower intends to reach the SPTs and (v) any other key factors that may affect the borrower achieving the SPTs.

The borrower and lenders will agree on and set the appropriate KPIs and SPTs for a transaction, and a sustainability coordinator or structuring agent may be appointed to assist the lenders in negotiating and calibrating the SPTs with the borrower.

Borrowers are encouraged by the SLLPs to seek input from an external party as to the appropriateness of the KPIs and SPTs (for example, by a pre-signing Second Party Opinion as to the appropriateness of the agreed KPIs and SPTs as a condition precedent to the SLL being made available).

Where no external input is sought, the SLLP strongly recommends that the borrower demonstrates or develops the internal expertise to verify its methodologies, including the related internal processes and expertise of its staff (which should be thoroughly documented). Naturally, this documentation should be provided to lenders participating in the loan. Market practice in relation to whether external verification is sought is still developing and varies on a deal-by-deal basis.

Closing Thoughts

In the next installment in this Sustainability-Linked Loans Series, we will continue our deep dive into the Core Components and look at loan characteristics, reporting progress against SPTs, and verification.