SLAUGHTER AND MAY/

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SUSTAINABILITY-LINKED LOAN PRINCIPLES UPDATED

WHAT HAS CHANGED?

The Green, Social and Sustainability-Linked Loan Principles (together the Loan Principles) specify the criteria that qualify a loan as green, social or sustainability-linked. Although closely adhered to in practice, they are not regulatory requirements – rather voluntary recommended guidelines aimed at protecting the integrity of the sustainable loan market. The Loan Principles are reviewed on a regular basis to keep pace with market practice and the evolution of sustainable loan products.

New versions of all of the Loan Principles and related guidance were published on 23 February 2023, reflecting the conclusions of the latest review. The updated material is available on the LMA's Sustainable Lending microsite. There are a significant number of changes, but many of the amendments simply expand and add colour to previous content or are aimed at aligning the drafting more closely to the text of ICMA's equivalent guidelines for the bond market.

This Briefing considers the key changes made to the Sustainability-Linked Loan Principles (SLLP), their impact on future sustainability-linked loans (SLLs) and the extent to which they are relevant to SLLs already in existence. The updates to the Green and Social Loan Principles are addressed in a separate briefing.

Key points

Amendments have been made to every section of the SLLP, each of which are considered in turn below. Key points include:

- **Amplification of the requirements for materiality and ambitiousness in relation to KPIs and SPTs respectively:** This includes increased emphasis on benchmarking, the latest SLLP suggesting "materiality assessments" as best practice when selecting KPIs. Also new and notable are requirements that SPTs should be set beyond targets required by regulation (as well as beyond a business as usual trajectory as previously required) and that SPTs must be set annually and remain ambitious throughout the life of the loan.

- **Firmer direction on disclosure and transparency requirements**: A number of the changes reflect the increasing focus placed on transparent reporting and public accountability as a protection against greenwashing. The SLLP now more clearly underline both that there should be annual reporting against SPTs set during each year of the loan and the nature of the borrower's deliverables.

- **Views on certain newer SLL terms and structures:** SLL terms have rapidly become more complex and sophisticated over the last 6-12 months. The SLLP and accompanying guidance have been expanded to address, and in some cases provide more detailed views on, the SLL terms and structures that are cropping up in practice, for example "sleeping SLLs".

SLL definition and fundamentals

Recast definition of an SLL

A newly recast definition of an SLL reads as follows:

> *"…any type 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 revised definition puts the ambition, materiality and quantifiability of the SPTs front and centre, reflecting one of the key themes of the revisions; the emphasis on targets that are material and beyond business as usual.

The accompanying guidance note (the **Guidance**) adds Schuldschein to the list of financings which can comprise an SLL (reflecting that a number of such products have been issued in SLL form).

Clarification that SLLs are a transition tool for borrowers of all types

The Guidance on the fundamentals of SLLs highlights that the product is a transition tool, designed to support borrowers in improving their sustainability performance (wherever they might be on that journey). As a result, there are no minimum requirements in terms of a borrower's ESG performance or exclusions in terms of business activities or practices - SLLs are intended to be accessible to all borrowers, regardless of sector, geography or level of sustainability, provided they deliver alignment with each of the core components of the SLLP. Having said that, the Guidance also alludes to the fact that borrowers in controversial sectors or industries (or who are exposed to issues that are controversial from an ESG standpoint) should expect heighted transparency requirements from lenders so they can evaluate the SLL package in light of such controversies.

Application of the updated SLLP

The updated version of the SLLP includes an explicit grandfathering provision. Loans currently being negotiated can be labelled as SLLs if aligned with the previous version of the SLLP, provided they are completed before March 9 (two weeks from the date of publication of the updated SLLP). All loans originated, extended or refinanced after March 9 must be aligned with the updated version.

The inclusion of this grandfathering provision highlights expectations that when an existing SLL is extended or refinanced, the extended/refinanced transaction may need to be reviewed in light of any intervening changes to the SLLP. The Guidance does not express a view on the position if an SLL is otherwise amended, or, if an SLL is extended pursuant to in-built extension options; it is assumed that in those circumstances the parties would take a practical approach.

Core Component 1 - Selection of KPIs

Materiality

The language around Key Performance Indicator (**KPI**) requirements has been strengthened. KPIs "must" be material to the borrower's core sustainability strategy (previously KPIs "should"…). Further, when considering the rationale for selection of KPIs, whether the KPI is core to the borrower's business has been included as an additional consideration.

With regard to benchmarking of KPIs, there is now a clear requirement to benchmark against industry peers as well as industry standards, where feasible. In the previous version of the SLLP, this was noted in relation to SPTs only. A new footnote states that the calculation methodology for any KPI should follow international standards and science-based methodologies where available.

Appendix 1 of the SLLP, which previously listed examples of categories of KPIs, has been deleted in its entirety. Readers are instead signposted in a new footnote to the Guidance for examples of benchmarks/standards/frameworks that can be used to identify relevant and material KPIs, of which there are now a number.

The Guidance on what "materiality" means in the context of selecting KPIs has also been rewritten and expanded. It now emphasises that materiality can be assessed from a strategic standpoint, i.e. by looking at the ESG challenges that are most material for the borrower and sector, and/or from a sustainability standpoint, i.e. by looking at the ESG issues that have the greatest impact on society/the environment. It is made clear that best practice is to benchmark proposed KPIs by conducting a materiality assessment. Examples given of external guidelines and tools borrowers may use to undertake a materiality assessment are the Global Reporting Initiative, SASB, TCFD, ICMA's Illustrative KPI Registry, the International Integrated Reporting Council's Framework, the Accountability's Materiality Framework and the various reports produced by the EU Sustainable Finance Platform.

Third party involvement

The Guidance goes on to note that a "*growing number of organisations are performing these assessments in accordance with ESG reporting frameworks and standards*". In practice, some borrowers do engage ESG consultants or other third parties to assist in this regard; however, in the context of SLLs, it remains fairly common for KPIs to be identified and assessed as a collaborative effort between the borrower and its relationship banks.

ESG ratings as KPIs

Until the most recent update, the Guidance had explicitly contemplated the use of third party ESG ratings as a KPI. References to ESG ratings in the context of SLLs have, however, now been removed. This deletion does not stop market participants from using ESG ratings as an ESG metric where appropriate, but perhaps reflects concern among lenders with regard to their ability to assess and compare such ratings, which, for now, remain unregulated. In practice, ESG ratings are not frequently used as KPIs in SLLs in any event.

Core Component 2 - Calibration of SPTs

Ambitious – on an ongoing basis

Similar to the provisions on KPIs, the language around SPT requirements has been strengthened – SPTs "must" be set in good faith and remain relevant and ambitious throughout the life of the loan (previously SPTs "should"…).

There are two particularly notable new requirements with regard to SPTs. Firstly, that SPTs should be set beyond targets required by regulation (as well as beyond a business as usual trajectory as previously required). Secondly, the requirement for SPTs to remain ambitious throughout the life of the loan.

The Guidance expands on the meaning of these requirements, providing that as long as SPTs are set in good faith and remain relevant and ambitious, they can be drawn from borrower's publicly announced targets – but subject to safeguards in documentation to allow for the SPTs to be updated so they are never less ambitious than those publicly announced (i.e. the SLL must keep pace with adjustments to the borrower's strategy and targets).

The recasting of SPTs as something dynamic that should be regularly reviewed reflects lender concerns that are currently quite apparent in practice. A "rendezvous" clause features in most SLLs. There is limited consistency in terms of the detail, but the clause, in essence, describes a set of circumstances in which the ESG provisions of the SLL can be re-opened during the tenor of the loan. The triggers often include where there are changes to the borrower's business, but also, may extend to the KPIs/SPTs ceasing to be aligned with the SLLP (which in the context of SPTs, could be because they are no longer considered "ambitious").

The SLLP also feature a new recommendation that an annual SPT be set per KPI for each year of the loan term. This reflects the approach to SPTs that has become typical in SLLs (in contrast to sustainability-linked bonds, where SPTs are set much less frequently, often only once during the tenor of the bond). However, the SLLP acknowledge that exceptions may apply where there is a strong rationale (which is also apparent in SLLs extended to certain borrowers in practice).

Contextual reference points

The Guidance with regard to the calibration of SPTs (i.e. the bases on which they should be set) states that SPTs can be (i) external and set by reference to science; (ii) external and set against a borrower's ESG performance in relation to its peers; (iii) internal and bespoke to the borrower's business, referencing past performance where possible; or (iv) a combination of any of these.

This part of the Guidance has been extended to confirm that selection of both KPIs and SPTs (and their materiality/ambitiousness) must be contextual i.e. by reference to the borrower's sector(s) of operation, giving account to local context. Where feasible, SPTs should be set in line with or (where possible) beyond official country/regional/international targets.

A distinction between developed and less developed economies is specifically noted – as well as highlighting that differences in social factors such as demographics and gender equality in the regions where the borrower operates can mean that what is regarded as an ambitious target in one region, may not be accepted as ambitious in another. This acknowledgement is potentially helpful to borrowers in markets where the SLL product is still at an early stage of development.

Involvement of Sustainability Coordinator/third party

The Guidance highlights that the calibration of SPTs is a process that involves benchmarking and periodic review. The SLLP and the Guidance highlight that lenders and borrowers may require some assistance in that process.

To that end, the section in the SLLP on the calibration of SPTs articulates the role of Sustainability Coordinators in SLLs: to assist with providing market colour regarding the KPIs and SPTs to the borrower, to facilitate dialogue between the borrower and lender group in regard to substantiating the SPTs and to answer ESG-related questions the prospective lender group may have. This is an accurate representation of the general role of the Sustainability Coordinator in practice, and reflects the position already expressed in the Guidance.

There remains no suggestion that the appointment of a Sustainability Coordinator is mandatory. Lenders are also reminded in the Guidance of the need to review SPTs for themselves even if a Sustainability Coordinator is appointed.

Sleeping SLLs

"Sleeping SLLs" are loans which include the SLL margin adjustment mechanism and reporting provisions but leave the KPIs and/or SPTs that bring those provisions into operation to be agreed at a later date. This structure has been controversial, in particular given that the SLLP require that the SPTs be set "before or concurrently with origination of the loan". Nonetheless, a number of sleeping SLLs have been successfully completed.

The updated Guidance highlights that sleeping SLLs should be approached with care, but does not rule them out altogether. It notes that sleeping SLLs are appropriate only in exceptional circumstances (for example on deals where time is pressured, and the borrower already has a clear sustainability strategy in place) and places conditions/parameters around their use. These include: (i) that the loan is not an SLL and should not be communicated as such (until the SPTs are agreed and set, and all other core components of the SLLP are met), (ii) that the switch from "sleeping SLL" to SLL should take place no later than 12 months post-origination, (iii) that the parties should ensure the SPTs undergo the same scrutiny and attention as they would have had they been proposed at the outset of the transaction and (iv) a recommendation that all lender affirmative consent be required to the setting of any SPTs (although it is acknowledged that there may be cases where this is not practicable due the size of the syndicate in which case parties may agree a lower consent threshold).

The Guidance does not explicitly address "sleeping" structures where KPIs (as well as SPTs) have not been identified. There are examples of sleeping SLLs without KPIs in practice – in particular, SLLs which include incomplete KPIs (which contemplate the addition of further KPIs after the date of the agreement). It may be that addressing KPIs in this context was not deemed necessary – the requirement in the SLLP which has, to date, sat uncomfortably with the "sleeping" structure is the requirement that the SPTs be set "before or concurrently with origination of the loan". The SLLP are, however, silent on the timing of the setting of KPIs. In any event, the SPTs cannot be set without KPIs so by addressing SPTs in the context of "sleeping" structures, one is necessarily also addressing the setting of KPIs.

Core Component 3 - Loan characteristics

The "Loan Characteristics" that form part of the core components of an SLL are limited to the economic outcome i.e. that the margin "will often" be reduced where the borrower meets an SPT and increased when the SPT is not met. The key addition to this section is a note that, in some cases, "*where a strong rationale is provided*", the ratchet may include a neutral bracket in which no margin adjustment applies.

This description reflects how margin ratchets on many SLLs operate in practice. It is interesting that the section goes no further in describing other terms that are characteristic of SLLs. This is potentially due to the still divergent range of views in practice on whether particular clauses (for example, "declassification" provisions that specify the circumstances in which the loan will lose its sustainability-linked label) are "standard" or to be applied only in appropriate cases.

Debates about documentation terms are anticipated to become more focussed with the publication of the LMA's SLL Rider, which is expected to contain template drafting for a range of provisions for market participants to consider. The upcoming publication is noted in the Guidance, alongside the recently published LSTA drafting guidance for the New York law market, and the APLMA's term sheet for the APAC market.

Core Component 4 - Reporting

Reporting requirements have, in practice, crystallised into a requirement for annual reporting, which encompasses a sustainability report (often the borrower's public reporting) plus a sustainability compliance certificate that outlines the borrower's performance against the SPTs for the relevant year and the related impact and timing of such impact on the SLL margin. The compliance certificate is also in most cases accompanied by a report from an auditor or other external reviewer.

Reflecting this practice, the SLLP no longer caveat the requirement for the borrower to report annually with the words "where possible". The deliverables now also include a "sustainability confirmation statement" with "verification report" attached (as to which, see below).

Core Component 5 - Verification

Pre-signing external review remains recommended (not mandatory)

The SLLP continue to reflect that the need for a pre-signing external review in the loans context will be considered on a case-by-case basis. Pre-signing external reviews, in the form of second party opinions, are standard practice in relation to ESG bond products. The difference in approach between loans and bonds here acknowledges that lenders are likely to have a more in-depth understanding of the borrower and its operations. The SLLP continue to note the possibility that borrowers may have the internal expertise to ensure alignment of the SLL with the SLLP, subject to lenders being provided with evidence of the same.

While pre-signing external reviews are not mandatory for loans, the SLLP nonetheless continue to recommend them (whether in the form of second party opinions or something else - a new reference to pre-signing "KPI/SPT assessments" has now been included as an alternative to second party opinions). The reference to a pre-signing external review being obtained as a condition precedent to the SLL being made available has, however, been removed.

Post-signing "verification" is mandatory

The SLLP are now very clear as to what is required in terms of verification of the borrower's performance against the SPTs:

> *"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."*

The SLLP previously required external verification reports at least once per year - the change in the provision quoted above is that verification is now required for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the margin. This caters for SLLs that may work to different time periods. The requirement that information "must be shared with lenders in a timely matter" is a supplement to the pre-existing requirement to make such information public where appropriate.

Note that borrowers are also encouraged to ask external reviewers to assess any material changes to the ESG metrics post-signing (part of Core Component 2).

New Guidance adds colour to the range of possible contents of a verification report:

- the level and type of verification, for example whether a limited or reasonable assurance, or other engagement has been conducted and the standards applied;
- a description of the procedures conducted by the practitioner and any inherent limitations;
- a description of the subject matter of verification and the criteria, such as sustainability standards used to assess conformance; and
- confirmation of the practitioners' independence and conformance with quality management systems.

There has been some debate as to the correct terminology in this context, specifically whether the correct term is in fact "assurance" rather than "verification". In the event, the term "verification" has been retained, seemingly due to the range of language used by external reviewers of different types - for example, auditors tend to refer only to assurance, others may provide verification services.

Looking ahead

The revised SLLP provide greater clarity on a number of features and expectations in relation to SLLs. They remain, however, high level and deliberately loose, the loan trade associations having made a conscious effort to allow market participants a degree of flexibility in the context of a developing market. The Guidance provides additional colour and has, as explained above, been substantially expanded on in this round of updates. However, for those entering the market for the first time, there are a number of questions that do not have prescribed answers.

Many of the open questions in the SLL context relate to the form and content of particular documentation terms. As noted above, the LMA is currently working to produce an SLL Rider, which it is aiming to publish in the coming weeks, a development which will be welcomed by many. This will contain a set of clauses and drafting options for SLLs, providing a common starting point for negotiations and, for first time entrants to the market, an idea of the nature and scope of the clauses that might be proposed or included.

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