Sustainability-Linked Loans

George Tong T: +852 2841 6836 | E: george.tong@minterellison.com
Ada Luk T: +852 2841 6889 | E: ada.luk@minterellison.com

What are sustainability-linked loans?

Sustainability-linked loans (**SLLs**) are any types 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 a borrower achieves ambitious, material and quantifiable predetermined sustainability performance objectives.[1]

A SLL is intended to be a transitional tool which aims to encourage and incentivise a borrower to improve its sustainability performance and profile, and to attain a more sustainable business model from an environmental, social and/or governance (**ESG**) perspective.

This is achieved by aligning the loan terms of a SLL to the borrower's performance against predetermined key performance indicators (**KPIs**) and sustainability performance targets (**SPTs**). If the borrower is able to meet such KPIs and SPTs, the borrower may benefit from a reduced interest margin rate during the loan term. These mechanics are usually incorporated into the loan documentation at either the origination of the loan, or, alternatively, at a later stage during the loan term if the parties requires more time to set these KPIs or SPTs.

The Asia Pacific Loan Market Association (APLMA), the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA) have jointly published the Sustainability-Linked Loan Principles and relevant guidance, which provides an overview of the framework and fundamental principles of a SLL. The LMA has also, together with the European Leveraged Finance Association, jointly issued a best practice guide to sustainability-linked leveraged loans in October 2023 to supplement the Sustainability-Linked Loan Principles.

What are the benefits of a SLL?

For a borrower, if it is able to meet its KPIs and SPTs, it may benefit from a reduced interest margin rate during the loan term. Borrowing a SLL also sends a clear signal to the market that the borrower is serious about its sustainability performance and profile, and indicates to its stakeholders of the borrower's dedication to have a more positive impact on the environment and economy. This may also allow the borrower to benefit from other ESG-related investment and financing opportunities in the future.

A SLL is also mutually beneficial for lenders, as this shows a lender's support for more sustainable economic activities, which also enhances a lender's reputation and brand value.

What are the core components of a SLL?

The Sustainability-Linked Loan Principles set out a framework of five core components:

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

It is only after all core components of a SLL are met can a loan be communicated, or referred to, as a SLL.

How should a borrower select its KPIs?

According to the Sustainability-Linked Loan Principles, KPIs must 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;
- **measurable** or **quantifiable** on a consistent methodological basis, and the calculation methodology should be clearly defined; and
- **benchmarked** by reference to an external industry standard and a baseline definition in order to facilitate the assessment of the level of ambition of the KPIs and SPTs.

Generally, lenders will take into consideration the borrower's overall ESG profile, business activities and industry sector in evaluating the selection of KPIs, the level of ambition and the likelihood of the borrower achieving the SPTs.

[1] As defined in the Guidance on Sustainability-Linked Loan Principles jointly published by the Asia Pacific Loan Market Association (APLMA), the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA) in February 2023.

Further, the KPIs should capture those ESG issues that have the greatest impact and relevance on the borrower's business activity, operational and financial performance, and be consistent with its overarching sustainability strategy.

By way of best practice, the borrower should undertake a materiality assessment of its business and its industry sector in order to determine how to select its KPIs in a meaningful way. A borrower may also appoint a sustainability coordinator, who is typically undertaken by the lead lender in a loan syndication, to assist the borrower and the lenders in selecting and calibrating appropriate KPIs and SPTs which align with good market practice.

How should a borrower calibrate its SPTs?

SPTs should be sufficiently **meaningful** (that is, core to the borrower's business) and **ambitious** (that is, a target that represents a true reach for the borrower). In any case, the SPTs should represent a material improvement to the borrower's KPIs beyond "business as usual" trajectory and regulatory required targets. The Sustainability-Linked Loan Principles also recommend that an annual SPT should be set per KPI for each year of the loan term.

What loan terms are relevant to a SLL?

Generally, the following provisions will be required to implement a SLL:

- definitions of KPIs, SPTs, the relevant benchmarks and calculation methodologies;
- the annual reporting obligations of a borrower on its performance of the SPTs;
- the rights of a lender to verify the borrower's performance of the SPTs, such as information rights of the lender, information undertakings by the borrower, and verification by external reviewers;
- adjustments to the interest margin rate (or other incentives agreed between the borrower and the lender) if SPTs are met;
- the consequences if the SPTs are not met, which are typically that the loan will no longer be classified as a SLL, and reinstatement of original interest margin rate. However, according to the loan term provisions recommended by the LMA, a failure to comply with such SLL-related provisions would not constitute an event of default.

What are the reporting obligations of a borrower in relation a SLL?

According to the Guidance on Sustainability-Linked Loan Principles, to allow the lenders to assess the performance of the SPTs during the loan term, a borrower should report on its SPTs at least once per year, provide a sustainability confirmation statement (together with an independent verification report). Such statement and report should, among other things, provide up-to-date information on the KPIs and SPTs, and report on any changes to the calculation methodology or assumptions during the loan term. If there has been a change, the parties should reconvene to assess whether any adjustments need to be made to the KPIs and SPTs.

How should a borrower's performance of the SPTs be verified?

Generally:

- at the pre-signing stage, a second-party opinion provider, which is an independent reviewer with sustainability expertise, should be engaged to confirm the alignment of the SLL with the core components of the Sustainability-Linked Loan Principles and to assess the meaningfulness and ambition of the selected KPIs and SPTs; and
- at the post-signing stage and during the loan term, an independent qualified external reviewer (such as an auditor, environmental consultant and/or an independent ratings agency) should be engaged to independently verify the borrower's performance of its SPTs and to assess any material changes to the parameters, KPI methodology or SPT calibration.

The lenders will then evaluate the borrower’s performance against the KPIs and SPTs based on the report issued by the second-party opinion provider and external reviewer.

Next steps

The recent focus on improving ESG initiatives and corporate social responsibility across all industries have significant implications for businesses build a more sustainable future.

We expect that SLLs will become increasingly popular, and envisage that further guidance will be issued to tighten and improve the Sustainability-Linked Loan Principles as the market matures. Borrower and lenders are encouraged to monitor this space for updates on future developments.

We have a lot of experience in handling SLLs, please feel free to contact George Tong and Ada Luk for further details:

George Tong
Partner
T: +852 2841 6836 | E: george.tong@minterellison.com

Ada Luk
Senior Associate
T: +852 2841 6889 | E: ada.luk@minterellison.com