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# LSTA Issues Revised Sustainability Linked Loan Principles

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As interest in Environmental, Social and Governance ("***ESG***") financing has increased, Lenders are increasingly looking to offer financial products for projects or companies that are environmentally friendly, socially conscious or focused improving a company's relationship with, or impact on, its community. One such financial product that has grown in popularity is the Sustainability Linked Loan ("***SLL***"), which includes a key pricing mechanism tied to the sustainability operations of the Borrower. Based on the Borrower's sustainability policies and objectives, the Borrower and the Lender will identify key performance indicators ("***KPIs***") to measure the Borrower's progress towards sustainability goals and then set a sustainability performance target ("***SPT***"). By way of example, the Borrower and Lender might determine that the KPI is the reduction of Greenhouse Gas emissions in the Borrower's operations, while the SPT would be the specific percentage (such as 10%) by which emissions need to be reduced on a year over year basis. If the Borrower meets the SPT and reduces its Greenhouse Gas emissions by 10% each year, it would be eligible to receive a reduction in pricing under the SLL, which might be reflected as a decrease in the margin or interest rate that kicks in once the SPT is met.

Given the increasing popularity of SLLs, the Loan Syndications and Trading Association ("***LSTA***") developed guidelines to ensure the legitimacy and credibility of the SLL financial product as a means of facilitating and supporting ESG compliant economic activity and growth. Known as the Sustainability Linked Loan Principles (the "***SLLP***"), these voluntary guidelines were first published in May 2019 and together with the accompanying Guidance on Sustainability Linked Loan Principles (the "***Guidance***") identify five key components of SLLs and provide a framework to better define the recommended or required elements of an SLL. On May 27, 2021, the LSTA issued amendments to the SLLP and Guidance emphasizing that the terms of an SLL should support the core purpose of promoting ESG compliant activity and highlighting the need for sufficient transparency and disclosure avoid the risk or appearance of sustainability washing or misuse of the product. Specifically, the revised SLLP requires third-party verification of KPIs and significantly strengthens the Lender's ability to verify the appropriateness of KPIs, the viability and ambitiousness of the Borrower's ESG strategy and the methodology used for calculation of SPTs.

1. Selection of KPIs

The SLLP has always emphasized the importance of selecting appropriate KPIs that go to a material element of the Borrower's core sustainability strategy and align with identified challenges or goals of the Borrower's industry. However, the revised SLLP stresses the importance of selecting credible KPIs to ensure the integrity of the SLL financial product. In order to ensure credible selection of KPIs, the revised SLLP adds additional metrics around selection, including that KPIs should be able to be benchmarked as much as possible, using an external reference to assess the level of ambition of the SPT. The revised Guidance notes that a KPI is "able to be benchmarked" if its environmental or social impact can be compared to regulatory standards or relevant taxonomies, including objectives identified in international agreements such as the Paris Agreement or other industry standards. Finally, the revised Guidance also clarifies that providing a "clear definition of KPIs" entails providing an applicable scope such as explaining how the SPT is integral to the Borrower's sustainability or ESG strategy, in addition to the existing guidance that the KPI's scope and methodology need to be clearly identified.

2. Calibration of SPTs

While the SLLP has always required that any SPT needs to be ambitious, and set in good faith, the revisions recommend expanded disclosure and third-party input to help verify the suitability of the SPT. In particular, the revised SLLP states that disclosures as to the SPT should clearly identify the following:

- Timelines for achieving the SPT, including observation periods, frequency of review of the SPT and trigger events;
- To the extent that historical data is available, a verified baseline or science-based reference point as to the Borrower's progress, and a clear rationale for selection of such baseline or reference point;
- When relevant, a description of situations where recalculations or pro-forma adjustments of the SPT may be appropriate;
- A description of how the Borrower intends to achieve the SPT, such as a description of its ESG strategy, operating procedure, key actions to be taken and the expected impact of any key actions in quantitative terms, where possible (while being mindful of confidentiality and competition considerations); and
- Any key factors beyond the Borrower's direct control, that may affect the Borrower's ability to achieve the SPT.

Further, the SLLP continues to encourage the Borrower to seek input from an external party when selecting the SPT, including by obtaining a pre-closing opinion from an external reviewer assessing the relevance, robustness, and reliability of selected KPIs and benchmarks, the rationale and level of ambition of the proposed SPT, and the credibility of the strategy proposed to achieve such goals. In the event that any SPT is revised following the closing of a transaction, the Borrower is recommended to re-engage with the issuer of the pre-closing opinion to evaluate the changes, including any adjustment to the Borrower's methodology, strategy or applicability to the industry. While the SLLP previously recommended that if no external input is sought the Borrower should demonstrate or develop expertise to verify its methodology, the revised SLLP adds a further recommendation that the Borrower thoroughly document such expertise and provide to the Lender documentation demonstrating the validity of the methodologies used.

3. <u>Loan Characteristics and Reporting</u>

Few changes were made to the SLLP as to the key SLL components of Loan Characteristics and Reporting. Borrowers continue to be encouraged to transparently report up-to-date information to Lenders (and the public, where possible), at least annually, on the ongoing progress and continued relevance of the SPT. However, one notable change clarifies that when a Borrower reports its progress, it is encouraged to provide details of any underlying methodology used in its calculations.

4. <u>Verification</u>

In perhaps the most significant revision, where the prior version of the SLLP only recommended that Borrowers seek independent and external verification of their performance against each SPT for each KPI, the updated SLLP requires that the Borrower obtain independent and external verification by a qualified external reviewer with relevant expertise, such as an auditor, environmental consultant and/or independent ratings agency, at least once a year. The revised SLLP goes on to state that while the suggested pre-signing opinion in haynesboone

Calibration of the SPT remains recommended, third-party verification of the SPT and associated KPIs on an ongoing basis is a necessary element of an SLL. Once reporting is complete, the Lenders will then use the external review to independently evaluate the Borrower’s performance against the SPT and KPIs. This change is in contrast to many SLLs, which currently require the Borrower only to self-certify as to its progress and achievement of the SPT, without any independent verification or requirement to provide underlying data or calculations.

5. Appendix

Finally, the appendix of the SLLP has been amended to provide common categories of KPIs regarding both “social” and “governance” matters — an expansion from the prior version’s appendix which solely listed “environmental” categories. Examples of social improvements in which a KPI might seek to measure include human rights and community relations, affordable housing, data security, employee health and safety, employee engagement, diversity and inclusion, and employee training. Examples of governance improvements in which a KPI might seek to measure include business ethics and building strong corporate governance and transparency.

The updated SLLP will become effective for all transactions completed on or after June 3, 2021.

*This article was co-authored by summer associate Jacob Pearlman.*