SUSTAINALYTICS

a Morningstar company

Sustainability-Linked Loans

A Bridge to Connect Corporate Sustainability and Finance

Contents

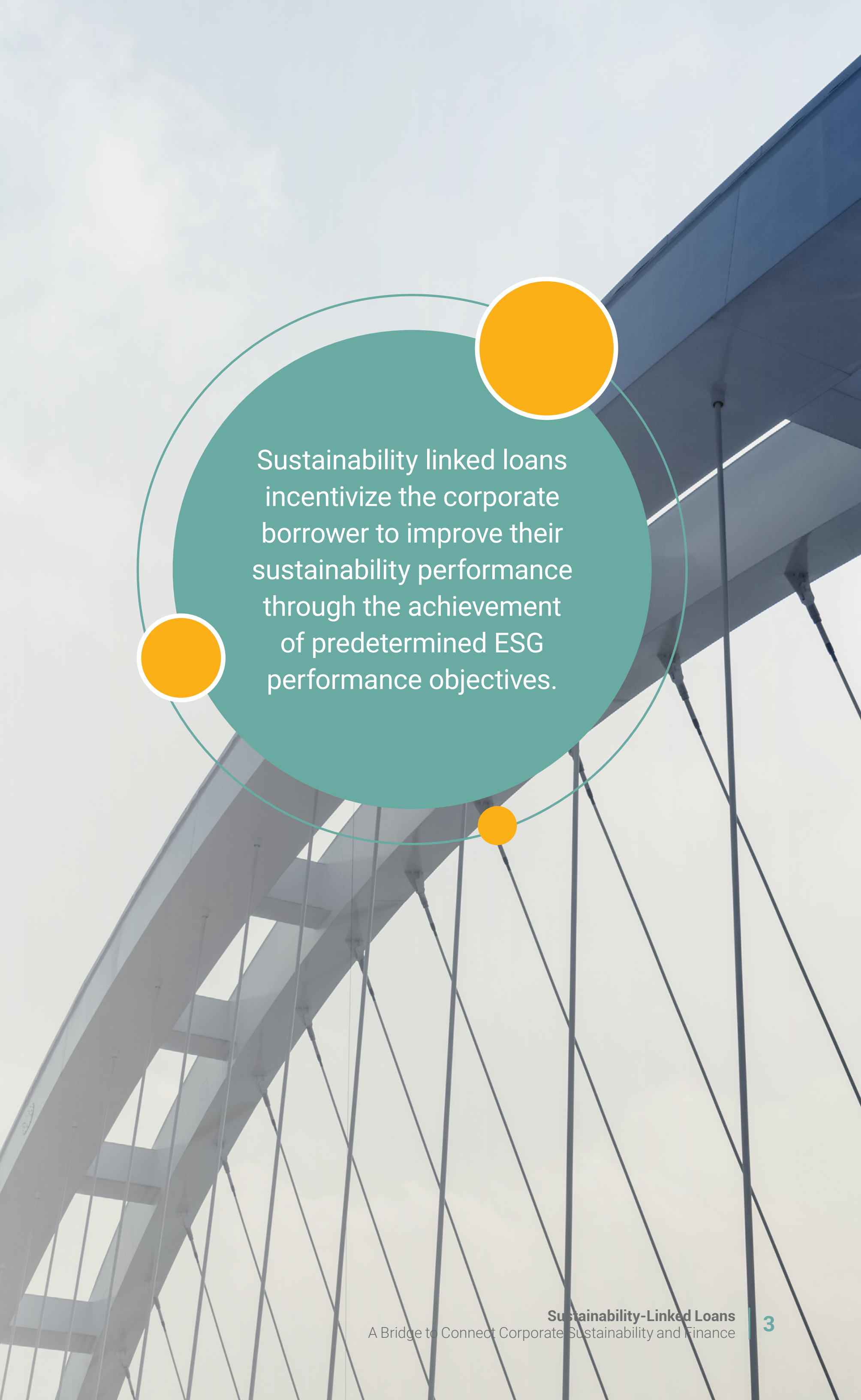
Introduction

Momentum for companies to address universal challenges such as climate change, social inclusion, and sustainable development has rapidly increased over the past decade. International agreements and frameworks, including the UN Sustainable Development Goals and the Paris Agreement, call for consolidated action from government, civil society and business to tackle these widespread environmental and social issues.

In response, innovative financial instruments have emerged to support improved corporate sustainability performance, including sustainability-linked debt, green loans, and green, social, blue, climate, and transitions bonds. Growth of these instruments has been significant: despite market volatility due to the COVID-19, sustainable debt issuance alone surpassed $700 billion in 2020, an increase of almost 30% compared to the year before.[i]

One innovative financial instrument contributing to the dynamic development of the sustainable financing market is sustainability-linked loans.[ii] A sustainability-linked loan (SLL) is a flexible loan instrument, which incentivizes the corporate borrower to improve its sustainability performance through the achievement of predetermined ESG-related performance targets such as reduced carbon emissions or an improved ESG rating. Loan terms are tied to the realization of these targets, spurring meaningful environmental and social change within the organization as well as demonstrating the company's sustainability commitment to both internal and external stakeholders. As there are no requirements for the use of proceeds, companies can use SLLs for general corporate purposes, making this instrument an attractive financing option for companies across industries – even among those traditionally not considered "green." Over the past three years, issuance of SLLs has risen rapidly across regional markets, with companies ranging from AccorHotels to Sydney Airport entering into SLLs.

This ebook examines the core components of this increasingly popular financial instrument, highlights the importance of setting ambitious sustainability targets when entering into an SLL, and explores how SLLs can not only bolster corporate ESG improvements, but also benefit companies' bottom lines.



Sustainability linked loans incentivize the corporate borrower to improve their sustainability performance through the achievement of predetermined ESG performance objectives.

The Emergence of Sustainability-Linked Loans

Sustainability-linked loans seek to improve the corporate borrower's sustainability profile over the term of the loan by tying the loan terms to the company's sustainability performance. Any type of loan financing, including revolving credit facilities and term loans, can be used as an SLL.

Since the instrument's introduction in 2017, issuance of SLLs has experienced a dramatic rise across markets. Europe's debt capital markets lead in SLL issuance; however, U.S. markets are rapidly closing the gap. As of May 2021, U.S. debt capital markets issued over US$52 billion in SLL issuance, a 292% increase compared to all of 2020.[iii]

Loans Structured Through KPIs and SPTs

Under the terms of an SLL, an economic impact is linked to the achievement of the predetermined targets aimed at materially improving the corporate borrower's sustainability performance. The borrower's sustainability performance is measured by key performance indicators (KPIs), with one or more sustainability performance targets (SPTs) calibrated for each KPI prior to the loan's issuance. KPIs can vary across industries, but could include greenhouse gas emissions, water usage, or employee engagement. A third-party ESG rating, for instance, could be chosen as a KPI, with a certain rating improvement selected as the SPT.

While the design of the economic impact varies across SLLs, many leverage a two-way pricing mechanism in which a corporate borrower who achieves its SPTs may receive a discount on the interest rate margin, while facing a margin premium if it fails to do so. Recent innovations in SLLs' economic impact design include using the amount equivalent to the margin increase to fund internal sustainability-focused projects, thereby assisting the corporate borrower to raise its sustainability profile.

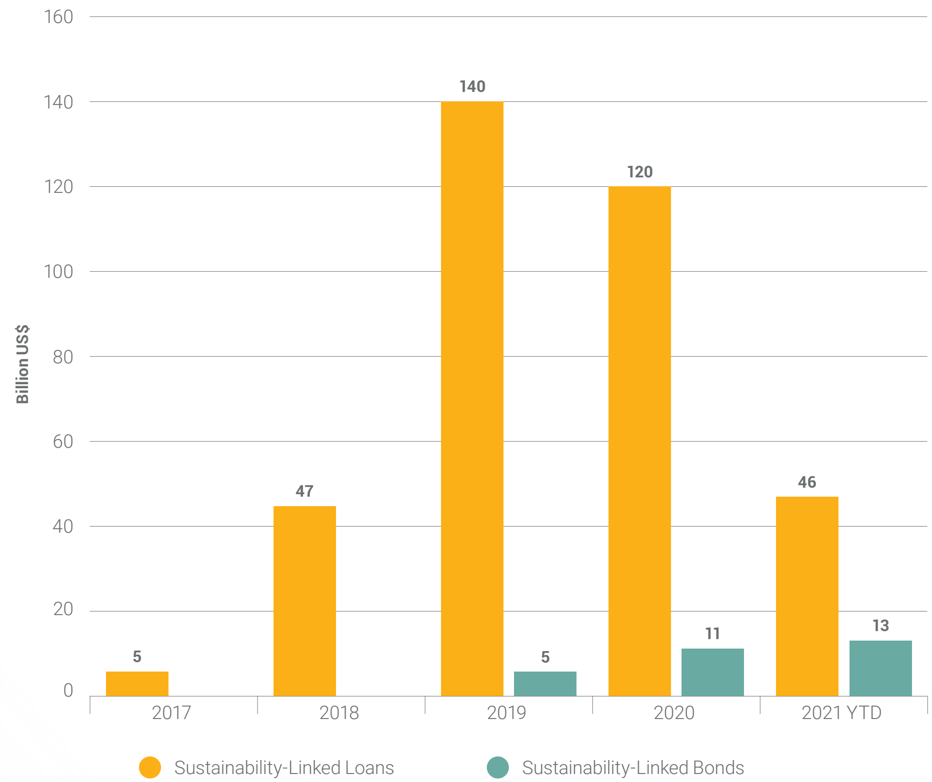
Compared to other forms of loan instruments and green lending, where proceeds are tied to specific ESG-related projects or capital expenditures, SLLs are highly flexible and sector agnostic. Financing raised from SLLs can be used for general corporate purposes, making it a highly beneficial and attractive financial instrument for companies. With the flexibility in the use of proceeds, SLLs have become a popular financing option across industries, with utilities, food products, and containers and packaging among some of the top industries.[iv] Philips, Danone and beverage company Anheuser-Busch InBev, are all recent examples of organizations leveraging SLLs as revolving credit facilities or term loans.

The Importance of Ambitious SPTs

Given SLLs' intention to incentivize corporate sustainability improvements, the selection of relevant KPIs and the calibration of ambitious SPTs are crucial in structuring an effective SLL and for the continued success of this financial instrument. Without a robust selection process, the credibility of the financial instrument is undermined, and accusations of greenwashing can occur.[v] Irrelevant KPIs or weak SPTs can also reflect low commitment levels by the company to make substantial sustainability improvements.

To provide guidance on market expectations when issuing SLLs, leading financial institutes in the global loan market developed the Sustainability-Linked Loan Principles (SLLP).[vi] The principles, last updated in May 2021, provide a voluntary, high-level framework for the issuance of SLLs, including detailing the core five components of SLLs that are necessary for the transaction to be viewed as credible by the market.[vii] Under the updated principles, corporate borrowers must clearly demonstrate that the selected KPIs and SPTs are relevant and material to their core sustainability and business strategy and address ESG challenges of their industry.

Global Issuance of Loans and Bonds Linked to Sustainability Performance Targets



Source: Bloomberg. Data through April 9, 2021. For informational purposes only.

SUSTAINALYTICS
a Morningstar company

Sustainability-Linked Loan Principles

Market expectations for SLLs are dictated by the Sustainability-Linked Loan Principles (SLLP), which provide corporate borrowers and lenders with a set of guidelines when developing an SLL. Jointly developed by leading financial institutions in the global syndicated loan markets, the principles underwent a structural revision in 2021 to provide greater clarity on the selection of KPIs and the calibration of SPTs.

According to the Sustainability-Linked Loan Principles, there are five components that define an SLL from other sustainable financing instruments:

Selection of KPIs

SLL KPIs should be clear, relevant to the corporate borrower's overall business and sustainability strategy, and ideally can be externally benchmarked to assist in the assessment of the SPTs' ambition level.

Calibration of SPTs

SLL SPTs should be calibrated to represent a significant material improvement and extend beyond a "business-as-usual" trajectory. SLL SPTs should be relevant throughout the term of the loan and, where possible, compared to a benchmark or external reference to facilitate the assessment of whether the SPT has been achieved, such as a science-based reference point or verified ESG rating as a baseline.

Loan Characteristics

With an SLL, an economic outcome should be linked to whether the corporate borrow meets the predefined SPTs. This could include reducing the margin under the relevant loan agreement when SPTs as measured by the predetermined KPIs are achieved or another predetermined pricing mechanism.

Reporting

Corporate borrowers should report to leaders at least once per year with information on their progress towards achieving the SLL's SPTs, as well as to determine whether the selected SPTs remain relevant and ambitious. Disclosures relating to SPTs are encouraged to be included in the company's annual or sustainability report but are not required.

Verification

Corporate borrower's performance levels against each SPT for each KPI must be verified by an independent and external party at least once per year.

A Closer Look at SPTs and KPIs

SPTs and KPIs: Ambition and Strength

In collaboration with the lender, corporate borrowers have the flexibility to link SLLs to internal and external KPIs to align with company-specific goals or industry-specific factors. KPIs and their associated SPTs can be internally gauged and bespoke to the organization, such as the number of training hours per employee, or externally benchmarked. External KPIs may focus on the organization's performance against its peers or be linked to a scientific benchmark, such as a science-based emission reduction target in line with the Science Based Targets initiative (SBTi).

When selecting KPIs, companies and lenders should consider the relevance of ESG issues to the corporate borrower's organizational and sustainability strategy, as well as to the broader industry. One important method to ensure KPIs are sufficiently relevant to a corporate borrower's business is to map possible KPIs against a materiality assessment of the borrower's industry.[viii]

The calibration of SPT(s) per KPI demonstrates the level of ambition the corporate borrower is ready to commit to in improving its sustainability performance. SPTs should reach beyond the current business-as-usual trajectory, remain relevant throughout the life of the loan and, where possible, be compared to an external reference or standard. Target setting should also include timelines of target achievement, key milestones, the frequency of reviews of the SPTs, as well as detailing the strategy of how the company intends to reach the SPT.

According to the updated SLLP, corporate borrowers must conduct annual post-signing verification of SPTs and KPIs and are encouraged to seek a pre-signing second-party opinion on the appropriateness of the selected targets. Obtaining a second-party opinion of KPIs and SPTs can lend credibility as to the ambitiousness of the targets to external and internal stakeholders alike.

Combining Internal and External KPIs for SLLs

Under the updated SLLP, selected KPIs should be material and specific to the corporate borrower's business operations, as well as being comparable across time and industry peers.

Internal KPIs can be unique to the corporate borrower or its industry. For example, Thai Union's US$183 million-equivalent SLL had a KPI of increasing monitoring aboard tuna vessels. On the other hand, an external KPI such as an ESG rating allows for peer-to-peer comparisons. As such, a combination of internal and external KPIs can provide a more holistic and credible picture of a company's sustainability performance as well as facilitating industry comparisons. Food processer and commodities trader, COFCO International, recently used a combination of internal and external KPIs by linking its US$2.1 billion SLL to improving its year-over-year ESG rating and bolstering its supply chain traceability efforts. Lenders may also prefer a wider selection of KPIs. ING, for example, often requires SLLs to be linked to three to five SPTs.[ix]

A combination of internal and external KPIs can provide a more holistic and credible picture of a company's sustainability performance.

SLLs That Have Used Sustainalytics ESG Risk Rating as the KPI

Borrower	Philips	International Seaways	Crown Holdings	COFCO	AccorHotels
Lender	ING	Nordea, ABN AMRO, Credit Agricole, DNB and SEB	BNP Paribas	Banking syndicate	Banking syndicate
SLL Value	€1 billion	$340 million	$3.25 billion	$2.3 billion	€1.2 billion
Year	2017	2020	2020	2019	2018
Country	Netherlands	U.S.	U.S.	Hong Kong	France
SPT	ESG Rating	KPI	ESG Risk Rating	ESG Risk Rating and KPI	ESG Risk Rating

For informational purposes only

The Benefits of Including an ESG Rating as a KPI

Compared to self-disclosed sustainability reports, ESG ratings are typically produced by an independent third party and provide consistent metrics to compare a company's ESG performance across time and industry peers. While variations in methodology exist across ESG rating agencies, a company's ESG rating is typically based on the company's exposure to ESG-related risks. Sustainalytics' ESG Risk Ratings, for example, capture the scope of an organization's unmanaged ESG risks by calculating the financially material ESG risks a company is exposed to and how well it manages those risks. An improvement in a company's overall ESG Risk Rating, therefore, indicates an improvement in a company's management of ESG issues or reduced exposure to ESG-related risks.

Considering an ESG rating provides an aggregate view of a company's ESG profile, ESG ratings should accompany another organization-specific KPI to capture the core ESG challenges of the business. The updated Sustainability-Linked Loan Principles requires a company to provide an explanation of why an ESG rating is the best material indicator for their business if using an ESG rating alone as a KPI. Including a third-party ESG rating as one of the SLL's KPIs has a range of benefits as listed below.

Getting a Holistic View of Sustainability Performance

Rather than needing multiple KPIs to capture a company's environmental and social impact profile, an ESG rating provides a comprehensive evaluation of a company's overall sustainability performance in one KPI. Depending on the ESG research agency, an ESG rating also captures the extent to which a company manages and mitigates against ESG-related risks. Sustainalytics' ESG Risk Rating, for instance, measures a company's exposure to ESG issues based on its industry and business model, as well as assessing the company's management approach towards those ESG issues.

Credible Measure of Sustainability Improvement

As ESG ratings are typically produced by independent ESG research agencies, using an ESG rating as a KPI can provide a neutral and up-to-date assessment of a corporate borrower's sustainability improvements. Alongside the company's self-reported data, many ESG research agencies draw from multiple alternative information sources to calculate and regularly update the ESG rating, including consulting regulatory filings, NGO reports, and media coverage of the company. This robust assessment process can add credibility as well as reduce reputation risks since the evaluation of whether the SPT is achieved—a marked improvement of the ESG rating—is conducted by an external party rather than by the borrower itself.

Convenient SPT for Corporate Borrowers

Internal SPTs may require considerable time and effort on the part of the corporate borrower to collect, aggregate and monitor the required data. Using a third-party ESG rating, in comparison, may require less effort and resourcing as an independent ESG research agency is responsible for calculating and updating the rating on a periodic basis. With the updated SLLP encouraging benchmarking KPIs against peers, using an ESG rating offers a comparable sustainability performance measure across industry peers and can circumvent the need for protracted market analysis.

Meets SLLP Verification Requirements

An ESG rating generated from an independent ESG research agency can fulfill the post-signing third-party verification requirements. Under the updated SLLP, corporate borrowers are required post-signing to secure third-party verification of their performance against the SLL's SPTs. Borrowers should also report on their progress towards their SPTs at least once per year to lenders, including providing details behind the methodology underpinning the assessment. With an ESG rating license, a corporate borrower can conveniently align the ESG rating updates to the loan cycle and any reporting requirements.

How ESG Ratings are Calculated

While differences exist among ESG rating agencies, most ESG rating systems consider two primary questions: what ESG-related risks is a company exposed to, and how well is it doing at managing those risks. To answer these questions, ESG rating analysts draw from a wide range of data, including a firm's self-disclosed ESG information, media sources, stock exchange filings, and governmental and NGO assessments. Core similarities in the methodologies underpinning the analysis of these data points include:

Step One: ESG Risk Exposure Assessment

A company's exposure to material ESG issues is assessed by a series of industry-level ESG indicators, such as water security, anti-corruption, and workplace health and safety. ESG indicators used by ESG rating analysts are regularly reviewed to align with the latest regulatory changes, scientific findings, and technological and social developments.

Step Two: ESG Risk Management Analysis

A company's management procedures for mitigating its ESG risks are measured across a company's policies, programs, practices and quantitative performance measures. Risks that could be addressed through suitable initiatives but are not yet managed can lead to a poor ESG rating. During this analysis, some rating agencies also examine potential ESG opportunities that could be leveraged by the company.

Step Three: Controversy Impacts Calculation

The likelihood and impacts of environmental, social or governance controversies are also factored into a company's ratings. This includes comparing a company's stated commitments to its actions on the ground. A controversial event — or high likelihood of such an event — such as corporate fraud or a chemical spill will lead to a lower ESG rating.

Step Four: Summation of Weighted Scores

Once the initial analysis is complete, a company's overall ESG risk rating is generally calculated by summing the weighted score of each unmanaged ESG risk. The score may also be calculated relative to the standards and performance of a company's global industry peers.

Step Five: Quality Review and Monitoring

A company's ESG ratings are systematically monitored on an ongoing basis and subject to quality review processes to ensure data accuracy. This includes monitoring emerging controversies and, in some cases, allowing companies to review ratings and provide additional data.

Corporate Benefits of SLLs

SLLs are quickly becoming a popular alternative to traditional capital raising and debt given their wide-ranging benefits for corporate borrowers. This innovative financial instrument presents the opportunity not only to bolster corporate sustainability efforts, but also to benefit the bottom line for companies.

Incentivize Company-Level Sustainability Improvements

Pre-signing, the company and lender must agree on ambitious SPTs that extend beyond "business-as-usual" improvements of ESG issues. In accordance with the updated SLLP recommendations, an external assessor should offer a second-party opinion on the selected KPIs and SPTs to review and lend credibility as to the relevance and ambitiousness of the targets. These independently verified commitments can focus and accelerate internal efforts to improve environmental and social sustainability. International Seaways, a US-based shipowner, linked its SLL to increasing the carbon efficiency of its fleet year-over-year in alignment with the International Maritime Organization's target to reduce greenhouse gas emissions by 50% by 2050. These year-over-year targets, supported by a linked pricing mechanism, have the potential to drive significant and material environmental and social sustainability improvements among corporate borrowers.

Flexibility in Use of Funds for General Corporate Purposes

Unlike green bonds or other labeled bonds and loans that mandate the use of proceeds to predetermined green or social projects, companies do not have to earmark funds for specific sustainability projects. Instead, companies have the flexibility to apply an SLL to general business purposes. This flexibility in the use of proceeds makes SLLs an attractive instrument for borrowers that don't have existing or upcoming capital expenditure projects eligible for green, social or other sustainability labels, or those operating in sectors that may not traditionally be considered "green."[x] Sydney Airport, for instance, highlighted the capital management flexibility of its AU$1.4 billion SLL, which is linked to improving its overall ESG performance as measured by its Sustainalytics' ESG Risk Rating.

Demonstrate Sustainability Commitments to Stakeholders

Committing to and achieving SPTs under an SLL can precipitate a positive impact on a company's reputation and credibility to both internal and external stakeholders. Unlike a simple public announcement on vague sustainability goals, SLLs provide an external commitment mechanism for a company to deliver on its ESG improvement targets, potentially even risking financial penalties if it fails to do so. This incentive structure can provide reassurance to external stakeholders of the company's commitment to sustainability and signal strong buy-in at the executive level. Internally, entering an SLL agreement can indicate to employees the importance the company is placing on improving its sustainability profile, which can bolster employee motivation as well as the ability to attract and retain staff.

> ESG-linked loans represent a crucial step in the right direction – leveraging today's financial landscape that rewards businesses committed to building a more sustainable future.
>
> – ResponsibleBusiness.com

Benefits of SLLs for Companies

- Access to discounted loan rates
- Improve overall sustainability performance
- Demonstrate sustainability commitments to stakeholders
- Flexibility to use the funds for general corporate purposes
- Deepen relationships and interactions with banks
- Drive internal alignment across the business
- Leverage third-party ESG ratings as additional assessment of sustainability

The Road Ahead for SLLs

Driven partly by the instrument's flexibility and the growing stakeholder demand for sustainable financing, the issuance of SLLs has experienced a meteoric rise since the first SLL in 2017. The revised Sustainability-Linked Loan Principles have boosted investor confidence and promoted market discipline, paving the way for sustained adoption by companies. To date, SLLs have been issued to a more diversified set of industries compared to other green loans and are expected to become increasingly popular in U.S. and Asian markets.[xi] Other forms of sustainability-linked debt, including the recent emergence of sustainability-linked bonds, are also on the rise. Given the growing popularity of sustainability-linked debt among corporate borrowers, it is anticipated that companies will develop their sustainable finance frameworks to align with both the Sustainability-Linked Loan Principles and [Sustainability-Linked Bond Principles](), allowing them even more options for future funding. As sustainability continues to redefine the debt capital market, SLLs are positioned to accelerate corporate borrowers' journey to a sustainable, low-carbon future.

SUSTAINALYTICS
a Morningstar company

Additional Resources

Corporate borrowers can use industry initiatives and standards to ensure an SLL's selected KPIs and SPTs are ambitious and relevant, including the Science Based Targets initiative, RE100, and the Transition Pathway initiative.

Other general resources on SLLs include:

Sustainability-Linked Loan Principles (SLLP): A voluntary and high-level framework on SLL issuance.

International Capital Markets Association (ICMA): ICMA's Sustainable Finance webpage provides resources and learning material on green, social and sustainability financing.

Sustainalytics ESG Risk Ratings: The ESG Risk Rating offers clear insights into a company's ESG performance across 20 material ESG issues and can be measured against industry peers.

Sustainalytics SLL Solutions for Companies

Sustainalytics offers several SLL solutions for corporate borrowers.

SLL Opinion Letter: Sustainalytics provides an independent opinion on the credibility of the SLL and its alignment with market expectations, such as whether the loan fulfills the five core components of a SLL as per the updated Sustainability-Linked Loan Principles.

ESG Risk Ratings License: Companies can license their ESG Risk Rating from Sustainalytics for use in their SLL agreement as an external KPI. Sustainalytics will also align annual rating updates with the loan cycle to meet the borrower's annual reporting requirements.

SLL Annual Review: Sustainalytics provides an assurance report on the alignment of each KPI performance with the communicated SPT, which is a mandatory component of the principles on an annual basis.

Is your company considering or in the process of getting a sustainability-linked loan? Sustainalytics can help. Contact us today to connect with our team of experts and learn more.

References

i Bloomberg (2020), "The Sustainable Debt Market is All Grown up," Bloomberg Green, accessed (13.5.21) at https://www.bloomberg.com/news/articles/2021-01-14/the-sustainable-debt-market-is-all-grown-up

ii SLLs may also be informally known as "ESG linked loans," "sustainability improvement loans," "KPI loans," "SDG linked loans" or "positive incentive loans."

iii Poh, J. and Seligson, P. (2021). "U.S. Sustainability-Linked Loans are 292% more than all of 2020," Financial Post, accessed (03.07.21) at: https://financialpost.com/pmn/business-pmn/u-s-sustainability-linked-loans-are-292-more-than-all-of-2020

iv Among Sustainalytics' clients that announced SLLs by value, the top five industries were Utilities (21.9%), Food Products (18.5%), Containers and Packaging (9.2%), Transportation Infrastructure (6.1%), and Household Products (4.8%) as of May 2021.

v Greenwashing and its variations of social washing and ESG washing describe situations where a company's sustainability claims are misleading or inaccurate. Accusations of greenwashing can occur when KPIs and SPTs are not sufficiently ambitious or meaningful, as well as inaccurate or weak monitoring and disclosing of a company's progress against SPTs.

vi The working group responsible for producing the Sustainability-Linked Loan Principles included representatives from the Loan Market Association (LMA), the Asia Pacific Loan Market Association (APLMA), and the Loan Syndications and Trading Association (LSTA).

vii The Sustainability-Linked Loan Principles were updated in May 2021 to align with market guidance around the sustainability-linked bond instrument.

viii A materiality assessment is a process of identifying and prioritizing ESG and other material issues that have a significant impact on a company and are important to its stakeholders. Material issues are those issues that are important enough to influence stakeholders' decisions in relation to the company, such as sustainable sourcing, cybersecurity, and social and economic inclusion.

ix Nauman, B. (2020)."Green loans catch on in push for companies to clean up," Financial Times, accessed (02.07.21) at: https://www.ft.com/content/d649cf78-35f8-11ea-a6d3-9a26f8c3cba4

x Nauman, B. (2020)."Green loans catch on in push for companies to clean up," Financial Times, accessed (02.07.21) at: https://www.ft.com/content/d649cf78-35f8-11ea-a6d3-9a26f8c3cba4

xi United Nations Conference on Trade and Development (UNCTAD) (2021). "World Investment Report 2021," UNCTAD, accessed (03.08.21) at: https://worldinvestmentreport.unctad.org/

SUSTAINALYTICS
a Morningstar company

Connect With Our Team of Experts to Learn More About Corporate ESG and Sustainable Finance

Sustainalytics, a Morningstar Company, is a leading global ESG research, ratings, and data firm supporting corporations and their financial intermediaries to consider sustainability issues in their policies, practices, and capital projects. As the leading second-party opinion provider in the market, Sustainalytics offers issuers credible verification on the use of proceeds for sustainable finance products. Corporations also leverage Sustainalytics' ESG Risk Ratings to understand and promote their ESG performance with their internal and external stakeholders. The firm has received awards in recognition of its ESG solutions and opinion services, most recently from Climate Bonds Initiative, Environmental Finance and GlobalCapital. With 16 offices globally, Sustainalytics has more than 1,000 staff members, including more than 350 analysts with varied multidisciplinary expertise across more than 40 industry groups. For more information visit www.sustainalytics.com.

Global Contacts

Americas
inquiries.Americas@sustainalytics.com
(+1) 347 630 9308

APAC
inquiries.APAC@sustainalytics.com
(+65) 6329 7596

EMEA
inquiries.EMEA@sustainalytics.com
(+44) 20 4526 5640

Japan
inquiries.Japan@sustainalytics.com
(+813) 4567 0198