FMSB
FINANCIAL MARKETS STANDARDS BOARD

Statement of Good Practice
Governance of sustainability-linked products

Introduction

Financial Markets Standards Board

Financial Markets Standards Board ("FMSB") was established in 2015 in light of the recommendations of the Fair and Effective Markets Review in the UK with a mandate to issue Standards designed to improve conduct and raise standards in wholesale financial markets. FMSB has built up a body of Standards ("Standards") and Statements of Good Practice ("SoGPs") over time, prioritising those areas where FMSB member firms ("Member Firms") consider there is a lack of clarity in the standards of behaviour expected of market participants, or a lack of understanding of the issues relevant to a product or transaction type, or evidence of poor conduct.

Applicability of FMSB Statements of Good Practice (SoGP)

SoGPs are issued by FMSB from time to time. SoGPs do not form part of FMSB Standards, and they are not subject to FMSB's adherence framework. Rather, they reflect FMSB's view of what constitutes good or best practice in the areas covered by the SoGPs in question. Member Firms are expected, and other firms are invited, to consider their own practices in light of the relevant SoGP and make any changes to such practices that they deem to be appropriate. Failing to do so will not, however, create any presumption or implication that a firm has failed to meet its regulatory or other obligations.

Full details of the Member Firms are available at https://fmsb.com/. SoGPs will be shared with non-member firms and their affiliates, who are encouraged to consider them. Information on SoGPs will be made available to users of the wholesale markets (e.g., corporates and end investors) so that they may be made aware of their existence and FMSB's expectation of market conduct. FMSB will, as part of its normal course of business, periodically review the applicability of its published SoGPs to ensure they are relevant and up-to-date for market conditions.

Relationship with law and regulation

FMSB Standards and SoGPs do not impose legal or regulatory obligations on Member Firms, nor do they take the place of regulation. In the event of any inconsistency, applicable law, rules, and regulation will prevail. In developing Standards and SoGPs, certain regulators may have commented on their drafting, alongside Member Firms and other bodies, such that the Standards and SoGPs, once finalised and published, are intended to represent an authoritative statement of global good practices and processes. However, they are not normally endorsed by regulators. Where they are endorsed by a regulator, that will be made clear on the face of the Standard or SoGP in question.

Relationship with other codes

Other Codes already exist in relation to certain markets, such as the FX Global Code, while others are in the process of being produced. Some overlap exists between the work of FMSB and such other bodies and FMSB will seek to ensure it adopts a consistent approach in cases of overlap wherever possible and will seek to avoid issuing a Standard or SoGP where the subject matter is already covered adequately by existing regulation, or a Code issued by another body. It may draw attention to Member Firms of an existing code and request that Member Firms act in a manner consistent with it once appropriate steps have been taken to confirm its applicability.

I. Explanation

1. Purpose

1.1 This Statement of Good Practice is intended to:

- Codify good practices for the governance of sustainability-linked products (SLPs); and
- Support the adoption of consistent governance approaches across asset classes and jurisdictions.

1.2 Enhancing governance practices for SLPs can help to improve the quality and integrity of SLPs; mitigate social or greenwashing risks; increase market confidence and investor trust in such instruments; and support the development of a deeper, more robust sustainability-linked product market.

1.3 This SoGP is intended to support, and be read in conjunction with, existing asset-class specific guidance set out in Section II, Paragraph 3 below.

2. Scope and applicability

2.1 This SoGP applies to Service Providers or Users of SLPs in wholesale financial markets (within the definition of SLP set out in II. Paragraph 1.1 below).

2.2 The Good Practice Statements (or GPS) reflect FMSB's view of what constitutes good or best practice. There may be instances where the GPS or supporting commentary is aspirational in nature. Service Providers and Users are expected to consider their own practices in light of the relevant SoGP and make any changes to such practices that they deem to be appropriate.

II. Context

1. What is a sustainability-linked product?

1.1 SLPs are products whose financial and/or structural characteristics can vary depending on whether the User achieves specific sustainability or ESG objectives[1]. These objectives are measured through pre-defined key performance indicators (KPIs) and assessed against sustainability performance targets (SPTs).

1.2 Unlike use-of-proceeds instruments, SLPs can be used for general corporate purposes, providing a flexible alternative for many Users to access the sustainable finance market.

1.3 While all SLPs share the same basic features, differences exist across products (e.g. loans, bonds and derivatives) due to instrument-specific characteristics and varying expectations of market participants. When interpreting this Statement of Good Practice, firms should bear in mind such differences.

2. Purpose of sustainability-linked products

2.1 SLPs aim to support sustainable economic activity through the linking of financial and/or structural product characteristics to pre-agreed KPIs and SPTs. As the market matures, SLPs may play a role as an instrument of transition, to support decarbonisation or help advancements across social metrics such as diversity, equity and inclusion or essential services.

2.2 Establishing strategic sustainability targets that are underpinned by direct financial implications through SLPs can increase the accountability of management when setting corporate targets and may also give rise to financial benefits or charges depending on whether targets are achieved.

2.3 The nature and degree of ambition of such targets vary across sectors and markets depending on factors such as the business model of the User, its strategic priorities or the availability of technology to drive change. This is important to recognise for the sustainability-linked market to develop across all sectors, particularly for those with less mature sustainability strategies.

3. Industry Guidelines

3.1 Industry bodies including ICMA, LMA, ELFA and ISDA, have released voluntary guidelines that set out guiding principles for the issuance of sustainability-linked bonds (SLB), loans (SLL) and derivatives (SLD). The principles include recommendations on structuring features, disclosure and reporting, and are intended for use by market participants to drive transparency and best practice.

3.2 Annex 2 sets out a non-exhaustive list of asset class specific industry guidance. This SoGP should be read in conjunction with such guidance.

[1] For the purposes of this document, the terms 'sustainability' and 'ESG' are used inter-changeably.

4. Risks associated with Sustainability-Linked Products

4.1 As outlined in paragraph 2 above, SLPs can be beneficial for Users, investors and the broader decarbonisation transition. However, they may also entail potential risks.

4.2 The growth of SLP issuances has been accompanied by concerns around the credibility of such instruments and the integrity of the broader market. Media and regulatory scrutiny[2] has led to heightened concerns around greenwashing and reputational risk for both Users and Service Providers.

4.3 Concerns have often centred on suggestions of low ambition and poor design in SPTs and KPIs. If Users are to set ambitious targets, missing such targets and the associated consequences will need to become a normal aspect of a well-functioning market.

4.4 Potential risks associated with the use of SLPs are detailed in the risk register in Annex I, grouped under four themes:

- Governance and approval processes
- Conflicts of interest
- Product characteristics
- User and investor considerations.

4.5 The risk register is intended to highlight potential risks not suggest solutions. Many of these risks can be mitigated through adhering to existing industry guidance. Robust governance frameworks, as outlined in this SoGP, can also assist both Users and Service Providers in addressing such risks.

[2] See for example the Review of the Sustainability-Linked Loans (SLL) Market letter (fca.org.uk)

5. Glossary

Term	Definition
Sustainability-Linked Product (SLP)	A type of financial instrument for which the financial and/or structural characteristics can vary depending on whether the User achieves predefined Sustainability/ESG objectives. Those objectives are typically: (i) measured through predefined Key Performance Indicators (KPIs); and (ii) assessed against predefined Sustainability Performance Targets (SPTs).
Sustainability-Linked Bond (SLB)	Any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/ESG objectives.
Sustainability-Linked Loan (SLL)	Any type of loan instrument and/or contingent facility (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.
Sustainability-Linked Derivative (SLD)	A derivative transaction with a sustainability overlay used to incentivize, through defined sustainability/ESG objectives, sustainability performance and/or to facilitate support for sustainable projects or issuers.
Key Performance Indicator (KPI)	A quantifiable measure of performance over time for a specific objective.
Rendez-vous clause	Express contractual provisions that allow for updates to KPIs and SPTs after a transaction has closed.
Service Provider	A bank or other financial intermediary acting as: (i) an SLL lender; (ii) a bookrunner, joint bookrunner or lead arranger (or other syndicate member including the Sustainability Coordinator) in relation to an SLB issuance; or (iii) counterparty to a SLD.
Sustainability Performance Target (SPT)	Measurable improvements beyond BAU trajectory in key performance indicators on to which Users commit to a predefined timeline.
User	Borrowers or issuers of, or counterparties to, SLPs.
Second Party Opinion (SPO)	An assessment of the alignment of the SLP framework with the relevant SLP principles by an independent third party. It can include an assessment of the User's overarching objectives, strategy, policy, and/or processes relating to environmental and/or social sustainability (if applicable)[3].
Sustainability Coordinator	A syndicate bank that will assist with the development and structuring of a SLP[4].

[3] External-Review-Guidelines_June-2022-280622.pdf (icmagroup.org), p.5
[4] The LMA has published a Sustainability Coordinator Letter to help agree the roles and responsibilities of a Sustainability Coordinator.

III. Good Practice Statements

The Good Practice Statements below should be applied in a way that is appropriate and proportionate to the size and nature of a User's business, having regard to different regional, sectoral or asset class-based approaches.

Integrity of SLPs

Interaction between Service Providers and Users

Good Practice Statement 1:
Service Providers should work with Users to improve the integrity of SLPs. When assisting[5] Users with their selection of KPIs and calibrating SPTs, Service Providers and Users should follow the relevant industry and asset class guidance.

Commentary

General considerations

Alignment between SPTs/KPIs and corporate strategy

Service Providers should consider with Users the alignment between the User issuing, or entering into, a SLP, the KPIs and SPTs selected and its broader corporate strategy. As part of its assessment, the Service Provider may consider the:

- robustness of the User's sustainability strategy and its transition pathway. Factors contributing to the robustness of sustainability strategy include how the strategy is supported by: (i) medium and long-term targets; (ii) a meaningful implementation plan; (iii) appropriate governance around, and external review of, the strategy
- quality of the User's sustainability reporting and governance frameworks
- User's overall business strategy.

Selecting KPIs and SPTs

When selecting and evaluating KPIs and SPTs, Users and Service Providers should evaluate whether the KPIs are sufficiently material and the SPTs are sufficiently ambitious, and follow best practices set out in existing industry guidance cited in Section II, Paragraph 3.

When selecting KPIs and SPTs for new SLPs, historic performance of a User against pre-existing metrics should be considered. If a User has significantly outperformed a SPT, Service Providers should consider the reasons for such outperformance, including through benchmarking, engagement with the User and whether performance is anticipated to continue on the same trajectory. Outperformance may be driven by additional initiatives and strategic decisions by the User, by unforeseen external events or may reflect

[5] Service Providers work with Users who ultimately select the KPIs. Service Providers do not act in a fiduciary capacity.

that the original SPTs were insufficiently ambitious. The outcome of this analysis should help inform the User's selection of metrics for future transactions.

Service Providers may encourage Users to publicly disclose the SPTs selected for a particular transaction (e.g. in sustainability reports).

Updating KPIs and SPTs

Before reapplying KPIs and SPTs to future transactions, Service Providers may conduct reviews of existing SLP transactions to ensure KPIs remain core, relevant and material to the User's business strategy and SPTs remain ambitious[6]. Review triggers may include receiving compliance certificates (during the life of the SLP) or evaluating a new SLP transaction for the User. Pursuant to such reviews, Users may update their suite of SLPs with revised SPTs to create alignment and facilitate tracking and monitoring of SPTs in use or outstanding.

For instruments with longer-dated maturities[7], if SPTs are achieved long before maturity, or if new KPIs are applied to other SLP transactions in the User's financing or hedging portfolio, Users should consider updating their KPIs for existing SLPs where appropriate.

Benchmarking

Service Providers may calibrate acceptable internal parameters for KPIs and SPTs across industries or client types to drive internal consistency in approach. This may include having a central database including peer examples of KPIs and industry/sectoral guidance to aid with benchmarking and inform future decision making.

Verification

Pre-issuance or signing - where appropriate, Service Providers may encourage Users to conduct a pre-signing/issuance external review, such as a second party opinion[8]. Users should follow existing guidance cited in Section II, para 3, setting out the scope and role of the external review provider.

Post-issuance or signing - Users should appoint an independent and external verification or review provider with relevant expertise to verify their performance against each SPT for each KPI (ideally on either a limited or reasonable assurance basis)[9].

[6] For SLBs the relevant ICMA guidance provides that 'any new SLB issuance should reflect the most up-to-date sustainability strategy of the issuer as described in its framework' (see SLBP Related Questions, February 2021, Section 4.4.8).
[7] Excluding instruments with annual SPTs.
[8] This in an expectation in the bond market pursuant to the ICMA principles but is unusual for loan transactions.
[9] Post issuance verification is a necessary element of the SLBP. The SLBPs also provide that 'the verification of the performance against SPTs should be made publicly available'.

Transaction-specific considerations

Syndicated transactions

For syndicated transactions, certain syndicate members may have limited influence over the nature and selection of KPIs. This is because KPI selection may be advanced or agreed between the User and Sustainability Coordinator prior to being socialised with the broader syndicate group. The late sharing of KPIs may also mean that syndicate members do not have sufficient time to discuss such KPIs with the User or Sustainability Coordinator or otherwise consider them in relevant internal governance forums.

There are certain steps that the Sustainability Coordinator can take to alleviate these issues, including:

- understanding syndicate member positions regarding KPIs and SPTs before finalising with the User
- responding promptly to questions from, and providing any relevant sustainability information to, other mandated syndicate members
- acting as a conduit between the User and other syndicate members, to relay information, for example if material concerns are raised about the robustness of KPIs or SPTs.

Prior to making any public disclosure referring to a transaction as 'sustainability-linked' and naming syndicate members, the User should obtain consent from such syndicate members.

Rendez-vous clauses

When using a rendez-vous clause[10] to amend the KPI or SPT definitions and/or to maintain alignment with the User's business and sustainability commitments over the life of the product, the selection of KPIs/SPTs should:

- be subject to the same standard of governance as those selected at origination as set out in GPS 4
- not result in the amendments to the SPTs being less ambitious than those originally set and continue to be consistent with the User's sustainability strategy
- follow relevant industry and asset class guidance as set out in Section 3, Paragraph II.

Both Service Providers and Users should be able to highlight to the other party any concerns associated with the use of a rendez-vous clause before the conclusion of a SLP.

[10] This is typically only relevant in the loan market.

M&A activity

When a company undergoes a merger or acquisition, it may prompt a review of its sustainability-linked structures in lending and other financial facilities[11]. While facilities may be retained, the KPIs and targets are often adjusted pursuant to the M&A activity. In such cases, Users should establish a clear timeline for reintroducing or adjusting the KPIs once combined tracking and reporting become feasible.[12]

Users of Sustainability-Linked Products

Good Practice Statement 2:
Prior to issuing or entering into a SLP, the User should outline its (i) strategic objectives for the transaction; (ii) internal process for measuring the outcomes; and (iii) appetite for pre-execution external review[13].

Commentary Users are encouraged to establish a robust sustainability strategy with clear reporting practices considering relevant industry guidance. The structures of the SLPs should align with the User's sustainability strategy. Service Providers can assist Users to assess SLP structures and the corresponding benefits and risks.

Users should consider:

- Reporting on their sustainability strategy (and transition pathway, where applicable)
- Identifying a tracking and reporting cycle prior to engaging in a SLP to facilitate reporting of progress against targets
- Utilising a credible and independent Second Party Opinion (SPO) provider to assess the alignment of the intended SLP with the relevant guidelines
- Adopting and utilising well understood metrics to measure KPIs to drive consistency and comparability across SLPs[14]
- Benchmarking KPIs, targets and respective commitments against industry peers and considering if and how these can be enhanced over time
- Disclosing agreed KPIs and SPTs in sustainability reporting or non-financial disclosures and procuring external verification of SPTs
- Where relevant for the product in question, sharing assured information with Service Providers on an annual basis indicating performance against the agreed SPTs (e.g. in the form of a compliance certificate)

[11] This may be contemplated in the relevant contractual documentation, for example under the 'rendez-vous' or 'sustainability amendment event' clauses.
[12] Specific product guidance may be applicable in this context (e.g. for bonds see ICMA SLBP Related Questions, February 2021, Section 4.3.7).
[13] Post-execution external review is required under existing product-specific guidelines.
[14] See, for example, ICMA KPI Registry.

- Periodically reviewing progress against long-term targets for instruments with longer maturities and including interim targets where appropriate for the instrument[15].

Users may elect to:

- move from limited to reasonable assurance where reasonable assurance of SPTs in respect of KPIs is available and practical (taking into account associated costs)
- conduct reasonable due diligence on any third party providing a verification service.

Governance and approval processes

Risk identification

Good Practice Statement 3:

Service Providers and Users of SLPs should take appropriate measures to identify and mitigate material risks, including any potential conflicts of interest, associated with such products.

Commentary

Service Providers and Users should refer to Annex I to guide risk identification.

To the extent material risks identified cannot be adequately mitigated, the Service Provider should refrain from using or offering the product or assist the User to find replacement KPIs and SPTs.

Governance process

Good Practice Statement 4:

Each Service Provider should have in place a robust and clearly defined governance process for the approval of SLPs. This process should be designed to drive a consistent internal approach to product and transaction approvals across all SLPs (irrespective of business line or jurisdiction). Decision making should include active consideration of the risks identified in GPS 3 and outcomes should be documented.

Commentary

Governance process

Existing governance and approval processes for non-SLP products and transactions should be supplemented with additional considerations specific to SLPs, including:

- reviewing transactions against relevant industry standards cited in Section II, Paragraph 3
- defining new product approvals for proposed transactions that deviate materially from relevant industry standards (see Section II Paragraph 3)
- implementing potential escalation procedures for novel or complex

[15] For SLLs the expectation is that unless a robust rationale is provided to the contrary, annual targets are set for the duration of the loan.

transactions or transactions that materially deviate from relevant industry standards without adequate rationale.

Transaction-specific governance and approval processes may consider a risk-based assessment of both the product and User. This would inform the compatibility of a SLP with the User's business and strategic objectives.

The nature and extent of transaction review may be influenced by factors including:

- the unique features or complexity of the transaction or whether there are concerns with the structure of the SLP (e.g. materiality or ambitiousness of the SPTs)
- the role of the Service Provider on the transaction and whether it is a bilateral or syndicated relationship (e.g. for SLLs)
- whether the Service Provider has a material influence over the selection of KPIs and SPTs or if concerns are raised regarding the SLP structure
- any involvement of an external reviewer
- the nature of the Users' business, size, geographical footprint, or the sector in which they operate
- the User's ESG track record.

The governance framework for the approval of SLPs should be designed to foster a consistent application of principles across all SLPs regardless of business line or jurisdiction. However, the decision-making outcomes may vary due to factors including differences in the maturity and structure across SLPs (bonds, loans, derivatives or other products), regional variations, each Service Provider's own internal rules and publicly communicated ESG targets and the nature of the User's business.

Timing

The decision-making process should allow reasonable time for relevant Service Providers to adequately review the sustainability information and KPIs/SPTs included in a proposed transaction. In particular:

- the User or Sustainability Coordinator (as applicable) should enable individuals with requisite expertise to have a reasonable period to review the sustainability-related features of a transaction to facilitate a robust assessment of a new SLP
- Users should allow a reasonable period for Service Providers, other than the Sustainability Coordinator, to revert and relay any questions or concerns to the User, or other Service Providers on the transaction.

Documentation

Service Providers should maintain documentation evidencing the SLP approval process. This may include details of individuals participating in the decision-making process, risk assessments, decision-making rationale, any relevant external reviews or opinions and interactions with other Service Providers or engagement with the User.

Escalation

In case of an escalation relating to the classification of a SLP as sustainable finance under GPS 6, the appropriate senior committee may be involved as an arbiter.

Classification governance

Declassification **–** a SLP may be declassified as 'sustainability-linked', with the sustainability provisions and margin adjustments ceasing to apply[16], in certain circumstances. These may include:

- the absence of Service Provider and User consensus on amended KPIs/SPTs selected following the trigger of a rendez-vous clause
- KPIs no longer being fit for purpose after pooling due to M&A activity
- failure to adhere to agreed reporting obligations on KPI or SPT performance or otherwise where a User's reporting materially impedes the Service Provider's ability to evaluate KPI/SPT performance.

Declassification may not be the result of an omission or fault of the User. Where a User does not achieve the SPTs it has set, this would not typically constitute a declassification event. A SLP should not continue to be marketed as sustainability-linked in the case of a declassification event.

The specification of declassification events should be considered in the context of the transaction and the relevant KPIs and will typically be addressed in applicable contractual documentation.

Reclassification – in exceptional circumstances, a transaction, having been declassified, may subsequently be reclassified as sustainability-linked. Applicable contractual documentation may specify if reclassification is permissible and otherwise this would need to be agreed between the relevant parties.

Role, responsibilities and composition of transaction governance forums

Good Practice Statement 5:
The mandate and composition of any Service Provider governance forums involved in the review and/or approval of SLP transactions should be documented. Such governance forums should have cross functional representation and include, as a collective, individuals of sufficient seniority, with an appropriate level of sustainable finance expertise and an adequate understanding of such products and the risks they represent to provide robust oversight and challenge.

Commentary

Mandate of governance forums

Service Providers should clearly define and document the roles and responsibilities of any governance forums involved in the review and/or approval of SLPs.

Different approval mechanisms may be appropriate depending on the

[16] As well as any other contractually defined consequences of declassification.

nature of the transaction. Examples include:

- formal/senior approval - some transactions may warrant more formal and senior approval. This may include complex transactions or those with unique features, if concerns have been raised regarding the structure of the SLP or transactions where the Service Provider has a material input into KPIs and/or SPTs
- fast tracked approval - fast tracked approval may be adopted for certain transactions. For example, SLPs for repeat Users, where subject matter experts in the first or second lines have no concerns with the structure of the SLP or its compatibility with the User's corporate strategy and relevant industry guidance. This may also be the case for third party verified targets which are assured.

Composition of governance forums

Governance forums should have cross-functional representation to ensure appropriate challenge and awareness of the risks inherent in the transaction. This would typically include representatives from:

- first line including deal team representatives and sustainable finance/ESG subject matter experts who may provide a defined assessment or challenge function
- second line including functions such as legal, risk and/or compliance.

Service Providers should seek to build sustainable finance expertise and capabilities across functions.

Sustainable finance targets

Counting of SLPs towards sustainable finance targets

Good Practice Statement 6:
Service Providers should have robust and consistently applied criteria for determining which SLP transactions count towards a Service Provider's sustainable financing targets. This should be consistent with the objective of seeking to ensure the credibility and integrity of the SLP market.

Commentary

Counting of SLP transactions to sustainable finance targets

Service Providers should establish procedures to ensure that criteria for determining which SLP transactions count towards their sustainable financing targets are consistently applied (where such targets exist). This may include:

- providing a rationale for the types of products and transactions that are deemed sustainable. This may be disclosed publicly through a sustainable or transition finance framework
- ensuring transactions comply with industry guidance as cited in Section II, Paragraph 3.

A SLP should not be counted as sustainable finance, or disclosed or marketed as such, unless/until KPIs and SPTs are included.

Classification decisions for SLPs should be documented and appropriate records retained by the Service Provider.

Annex I – Risk register

The themes, sub-themes and risk descriptions included in this Annex may be applicable across all sustainability-linked products or a sub-set of them. Such risks may not be unique to sustainability-linked instruments and may be also present, for example, in the context of use of proceeds instruments.

Key theme	Sub-theme	Description
Governance and Approval Process	Governance/ approval process	**Internal governance** • Different internal governance and approval processes for SLP transactions may mean approaches vary materially across the industry. This may for example lead to significant differences as to how banks classify SLPs as well as intra-institutional divergences across products. • Concerns around the level of expertise of individuals approving SLPs. **Robustness of Second Party Opinion (SPO)** • Third party external reviewers providing a SPO on SLP transaction should be independent, credible and trustworthy, and subject to review to ensure their assessment of SLP transactions is accurate and reliable. **Treatment of non-performing instruments** • Treatment of SLPs where the User consistently fails to meet its sustainable performance targets.
	Governance of amendment process of KPIs/SPTs	**Rendez-vous clauses** • Lack of external oversight and less stringent post-deal governance processes around amendments under the rendez-vous clause could increase greenwashing risk. • In the loan market, removal of KPIs from facilities post merger or acquisition activity with no timeline for their reinsertion.
Conflicts of Interest	Employee/Team vs Firm - counting of SLPs towards sustainable financing targets set at franchise level	**Counting of targets** • Desire to meet group, division, team or individual sustainable finance targets (e.g. as a result of objectives or remuneration being linked to such targets) could impact risk appetite to enter into SLPs giving rise to reputational risks for the Service Provider. • This is also applicable to internal KPIs relating to sustainable finance targets for corporates/sponsors.
	Service Provider vs User - counting of SLPs towards sustainable financing targets set at franchise level	• Internal pressure to meet sustainable financing targets may incentivise a Service Provider to encourage Users to enter into SLPs that could present greenwashing risk for Users. • The reverse can occur where a User pressurises Service Providers with whom they have a relationship to get comfortable with less robust or material KPIs/targets to support the User's strategic ambitions.

	Service Provider vs User - level of interest payable on loan[17]	• If the User meets the targets in the SLL then the Service Provider may receive a lower interest rate. The Service Provider could therefore be incentivised to encourage the User to adopt more challenging targets to ensure it continues receiving higher interest payments on the loan. Mis-alignment between the targets and the User's business model may also arise. • Ratchets are currently usually *de minimis* which reduces this conflict.
	Service Provider relationship with client vs clients' sustainability credentials	• Relationship between Service Provider and User could be prioritised over the User's sustainability credentials – the User may therefore influence the Service Provider's decision to participate in the SLP. • Ratchets are currently typically *de minimis* which exacerbates the conflict, since it is less financially material for the Service Provider.
	Choice of SLPs	• Service Providers could be incentivised by internal sustainable financing targets to encourage clients to enter into SLPs, rather than conventional loans, bonds or derivatives, even if they may not be the most appropriate option for the client. Alternatively less robust and material KPIs/ SPTs could be applied, resulting in a similar outcome. This risk is counterbalanced by increasing market and regulatory scrutiny.

Product Characteristics	**Use of proceeds products vs SLPs**	SLPs may be considered a transition instrument and proceeds may be used (in whole or part given that SLP proceeds are typically not attributed to specific projects) to finance activities that are not considered sustainable such as carbon intensive activities. While this may be consistent with the transitional nature of the instruments it could present risks of perceived greenwashing.
	KPI selection	**Relevance/ materiality of KPIs** • Low materiality or poor design of KPIs will result in less robust SLPs and increase the greenwashing and reputational risk. • KPIs not being sufficiently relevant or material. **Syndicated deals** The Sustainability Coordinator may have greater influence over KPIs and target setting, potentially leaving limited ability for other syndicate members to influence KPIs and targets applied. **Strength of KPIs vs number of KPIs** • Users may be inclined to prioritise quantity over quality of KPIs, when materiality should be the primary driver of KPI selection. • Setting too many targets may make it complicated for investors and Service Providers (where applicable) to track performance on an ongoing basis. However, in some instances multiple KPIs may be preferable in order, for example, to holistically encompass a material sustainability

[17] Applicable to SLLs.

	theme. Additionally, the distinction between 'core' and 'secondary' KPIs may influence the number of KPIs selected on a particular transaction.
Calibration of targets (SPTs)	**Targets insufficiently material/ stretching** Low ambition or poor design of SPTs result in less robust SLPs and increase the greenwashing and reputational risk for both the User and Service Provider. **Limited transparency of targets embedded in SLLs versus SLBs** Given the opaque nature of the SLL market, there tends to be less transparency of the SPTs embedded in SLLs compared to those embedded in SLBs. Opacity is particularly marked in bilateral loans compared with syndicated transactions. **Lack of interim targets[18]** Lack of interim targets in certain SLP deals can reduce accountability and make it harder to assess progress towards long-term targets. Interim targets are important for long-dated instruments due to the changing nature SPTs over time as new calculation methodologies are introduced and data and benchmarking improves.
Product characteristics/ penalties	**Inconsistency between KPIs and SPTs across products** KPIs and SPTs are not always aligned across products, despite their link to strategic sustainability objectives and ambitions. **Updating KPIs** KPIs may not be updated over time as they are achieved or diverge pursuant to amendment events across products. **Materiality of step-ups (incentives/ penalty mechanisms)[19]** • Step-ups in margin for failing to meet SPTs may be de minimis. Small coupon step-ups may provide limited financial incentive for Users to meet SPTs. • There is typically a difference in ratchets between SLLs and SLBs which may affect the materiality and impact if SPTs are not attained. • Difficult to set ratchet at a significant enough level to make the instrument impactful because it is hard to price these products in a way that is economical for both parties unless linked to the financial performance or risk profile. Ratchets may also be constrained by fair value accounting rules. **Correlation of penalties with coupon rate** SLB penalties may be smaller and uncorrelated with the coupon rate, implying that the limited financial incentive to reach a sustainability performance target decreases with the credit quality of the User and a higher rates environment. This issue is particularly relevant for high yield issuances as the coupon rate is higher. **Single-way margin ratchet** Single-way ratchets on SLBs penalise the User with a coupon step-up if they miss SPTs. This means there is only downside

[18] For additional guidance relating to SLBs, see SLBP Related Questions, February 2021, Section 4.3.9.
[19] For additional guidance relating to SLBs, see SLBP Related Questions, February 2021, Section 4.4.2.

		potential for the User which could reduce incentives for firms to go further than meeting SPTs. However, a step-down coupon may not be consistent with asset managers' fiduciary duties. **Callable SLBs** Absent contractual protections (which have become increasingly market standard), call options in SLBs may allow Users to recall the debt before the KPI observation date, if they believe the SPT would be missed. This could allow Users to avoid paying the penalty (coupon step-up) that would ensue if the SPT was missed. Investors may police this and penalise SLPs with this type of optionality. The likelihood of this occuring will be influenced by the prevailing interest rate environment.[20] **High yield vs investment grade SLPs** Due to lack of available data and disclosures for non-investment grade companies, KPI selection and target setting is more complicated in the high yield compared to investment grade market, leaving the high yield SLP market subject to greater reputational risk.

Investor and User risk considerations	**Opt-outs**	Lenders opting out of press release - lenders may enter into a SLL transaction with concerns around the robustness of the SPTs. As a result they may ask not to be included in the press release and will not count the deal towards their sustainability targets to avoid reputational risk considerations.
	Scrutiny of missed SPTs	Possible negative coverage associated with Users missing their SPTs may make Users reluctant to set more ambitious targets. Conversely, missing SPTs can reinforce perceptions as to the robustness of the targets and credibility of the market.
	SLPs under SFDR	Consideration of how SLPs are viewed under SFDR compared to use-of-proceeds instruments: • Typically UoP instruments will classify as Article 9 fund since some impact metrics are provided with third-party verification and they more clearly fit the sustainable objective of the investment. • SLPs will not necessarily qualify for Article 9 funds which could make SLPs a potentially less attractive product (this is not a determination for the Service Provider to make).
	Additional burden for the User and investor compared to traditional conventional products	• SLPs can entail additional burdens for both Users, e.g. potentially requiring an SPO and calibration of SPTs, and investors, e.g. requiring additional analysis, compared to conventional products. • Applicable governance frameworks mean that the time to close or launch deals is likely to be longer versus conventional deals with challenges can be greater in certain sectors and the high yield market.
	Sectoral and regional differences	Degree of standardisation and ability to benchmark SPTs and KPIs varies across sectors and geographies, influencing the degree of reputational risk both for Users and Service Providers.

[20] For additional guidance relating to SLBs, see SLBP Related Questions, February 2021, Section 4.3.5.

Annex 2 – industry guidance

A non-exhaustive list of key relevant industry guidance for sustainability-linked products across asset classes is outlined below.

The Sustainability-Linked Bond Principles, ICMA

- Guidance Handbook and Q&A, ICMA
- Disclosure data checklist, ICMA
- High Yield Sustainability-Linked Bonds Practical Recommendations, ICMA, ELFA
- Illustrative KPIs Registry, ICMA

The Sustainability-Linked Loan Principles, LMA

- Guidance on Sustainability-Linked Loan Principles, LMA
- Best Practice Guide to Sustainability Linked Leverage Loans, LMA, ELFA
- The ACT Borrower's Guide to Sustainability-Linked Loan Terms

Sustainability-Linked Derivatives KPI Guidelines, ISDA

- Sustainability-linked-Derivatives-Where-to-Begin.pdf (isda.org)