BEST PRACTICE GUIDE
for Private Debt
Sustainability-Linked Financing

FRANCE INVEST

1. Context

There are two main types of sustainable financing instruments :

- Financing dedicated to sustainable projects: the proceeds of the investment or financing are used solely to finance projects with environmental benefits (green bonds/loans), social benefits (social bonds/loans) or both environmental and social benefits (sustainability bonds/loans). This is currently the main type of sustainability financing in the public bond market.

- Sustainability linked financing (also called Sustainability linked loan, ESG KPI, ESG-linked, ESG adjusted, ESG-ratchet loans/bonds): the proceeds of financing ARE used for general corporate purposes, but there is a contractual commitment to meet Sustainability Performance Targets («SPTs») with an indexation of the cost of debt depending on whether or not these are met. The borrower's interest rate can be adjusted up or down depending on whether the «SPTs» are fulfilled. This is the main type of sustainable financing on the bank credit and private debt markets.

The increase in sustainability-linked financing on the private debt market can be explained by the growing interest in ESG issues from all stakeholders, and for the following reasons :

- The growing conviction that environmental, social and corporate governance issues – including the related risks and opportunities – can positively or negatively affect the long-term financial performance of borrowers and should therefore be closely monitored and managed;
- The desire of borrowers to translate their CSR strategy into concrete targets, with a clear roadmap and financial incentives;
- The desire of investors to take greater account of sustainability issues in their investment decision-making processes;
- The desire of private debt funds to participate in and provide guidance for transitioning companies;
- The measures taken by regulatory bodies to strengthen ESG transparency obligations (Article 29, SFDR...).

IMPACT INVESTING

Drawing on the work of the Global Impact Investing Network (GIIN), the France Invest Impact Investment Guide defines impact as the positive social and/or environmental externalities expected by investors. Impact is measured against specific objectives that have been defined in advance and are based on the investor's intention or, if applicable, the companies in which they invest. Therefore, sustainability-linked financing is not a sufficient criterion to qualify an investment strategy or debt as an impact.

2. Objective of the guide

The aim of this guide is to promote good practices among all stakeholders involved in the implementation of sustainability-linked financing. It also aims to improve and strengthen the integrity of these transition tools and avoid «green washing» or «impact washing».

3. Principles

A. ELIGIBILITY OF BORROWERS

To address global challenges, such as climate change or just transition, it is necessary to consider all economic activities. Thus, private debt investors, when considering sustainability-linked financing, will focus on the ESG improvement trajectories relevant to each sector or company.

Therefore, debt instruments indexed to ESG criteria should be available to all companies[1], regardless their sector provided that they have already defined or committed to define relevant KPI and SPTs. These debt instruments are applicable to loan, bond, revolving credit or other type of facility… It is the responsibility of debt holders to conduct a sound ESG due diligence analysis (in accordance with their internal procedures, exclusion policy, etc.) and then to assess the borrower's proposed sustainability strategy accurately, to ensure that **the Sustainability-linked financing** improve the overall sustainability profile of the borrower.

In order to capture the full sustainability strategy of the borrower and to ensure that the overall actions of the group are moving towards better sustainability practices, Sustainability-linked private debt issuance should be structured at the Group level rather than at the subsidiary level.

The debt holder's sustainability performance is measured using predefined Sustainability Performance Targets («SPTs») applied to selected Key Performance Indicators («KPI»)

B. PARTIES

Pre-invest

• ESG coordinator

In order to facilitate the structuring of Sustainability-linked financing, an ESG coordinator could be appointed to facilitate the process between the company and the lenders in the pre-investment phase. This task may be taken on by the arranger of the transaction, if any, or by any other lender.

The role of the ESG coordinator could be to :

- Identify, together with all lenders, the most relevant KPIs and the associated SPTs that are ambitious and in line with existing market standards (ICMA, ELFA…).
- Ensure that all potential lenders can discuss KPIs, SPTs and the margin adjustment mechanism during the pre-investment process.
- Provide data to assess the quality of SPTs (compared to benchmarks, reference scenarios, recognised frameworks, etc.).
- Provide advice and solutions to the borrower in relation to its sustainability strategy and action plans to achieve SPTs.
- Coordinate a Second Party Opinion, i.e. the opinion of an independent, expert third party, on the selection of KPIs and SPTs, if relevant. **In all cases, Debt holders should be consulted in connection with the selection of KPIs, SPTs and the interest rate adjustment grid during the pre-investment phase.**

[1] *Being specified that each investor is free to apply its own exclusion rules*

Core practices   Nice to have

Post-Invest

• ESG agent

The role of the ESG agent, which may be endorsed by the credit agent, if applicable, or by any investor, can be to ensure that ESG disclosure commitments to private debt investors are met within the timeframe set out in the legal documentation, and to report any changes (increase or decrease) in the SPT-related margin grid (see section D. Calibration of a Margin Adjustment Mechanism). The agent can also be responsible for organising negotiations between the borrower and the private debt investors regarding a potential waiver request or rendez-vous clause to discuss new KPIs and/or SPTs during the financing period.

• Independent auditor :

This may be an accounting firm, an ESG consultant or a rating agency. The auditor will be responsible for reviewing the level of performance of the borrower's KPIs against each of the SPTs included in the ESG compliance certificate (See section 4. Reporting and Review). The independent auditor is appointed by the borrower.

C. SELECTION OF KEY PERFORMANCE INDICATORS («KPI») AND SUSTAINABILITY PERFORMANCE TARGETS («SPT»)

Sustainability-linked financing requires companies to determine their sustainability objectives, which will be reached through KPIs and SPTs defined for the financing period. The choice of KPIs and SPTs should be made according to the following recommendations, in order to adopt best practices :

KPIs should be *inter alia* :

- **Core to the strategy :** central to the borrower's ESG strategy encompassing a broad spectrum of the group's activities, with potential for improvement and addressing the core ESG challenges of the industry.
- **Comparable :** they should be fully assessed using standards or benchmarks (including sector ambitions and/or trajectories if available) and based on a stable calculation method (e.g. the Global Reporting Initiative («GRI»), the GHG Protocol, the Science-Based Targets initiative, etc.)
- **Precisely defined :** The KPI's definition should include the method used to the SPTs, the scope of application (the entire group, preferably including subsidiaries), the impact of any acquisitions, etc. The use of composite indicators, with qualitative definitions or subject to interpretation should be avoided.
- **Transparent :** the level of performance of the KPI against each SPT should be audited by a recognised independent third party, via the ESG compliance certificate.
- **Limited :** it is recommended to have a limited number of KPIs (ideally up to 3). A single revelant KPI is preferable to a mix of non core KPIs. KPIs do not necessarily need to address one criterion per E, S or G pillar.

The calibration of a SPT should be :

- **Ambitious**, representing a significant improvement and showing some progress over time, and should be **specific, measurable, achievable and time-bound.**
- **Measured against past performance**[2], as a basis for comparison.
- Based on a **stable calculation method**[3] and on established ESG benchmarks to facilitate monitoring (borrowers will justify the credibility of the expected trajectory to the target by highlighting the measures to be put in place to achieve it).
- The first test period should occur **within a reasonable period of time** (usually one year after the closing).
- The timetable should be **in line with the maturity of the financing**, taking into account the fact that long-term financing should include intermediate deadlines, by means of a rendez-vous clause.

2 The last fiscal year period
3 The availability of past performance is an advantage

Core practices   Nice to have

The KPIs and corresponding SPTs should be established before the closing.

If this is not possible for one of the KPIs or if the whole trajectory cannot be defined, an amendment (rendez-vous clause) can be drawn up at a later date (agreement on the KPIs and SPTs at the rendez-vous will have to be based on the consent of at least a majority of debt holders (two-thirds)). The legal documentation should also include the possibility of amending the SPT if there is a major acquisition or regulatory change, subject to majority debt holders consent.

Debt holders should fulfill their fiduciary obligations and avoid any ambiguity related to a lack of ESG ambition that could undermine the credibility of this type of financing, and of the commitment in respect of the sustainability of the borrowers. Margin reduction should only be associated with the achievement of ambitious and relevant SPTs.

Management teams should have full control over the methodologies for achieving sustainability performance targets in order to limit the influence of external factors. As an example, we recommend that ESG ratings should not be used as KPIs since (i) there is possible methodological changes of rating models making the KPI obsolete over time and (ii) the objective of sustainability indexed financing is to accelerate the companies' transition through 2-3 key indicators and not a series of indicators composing an overall ESG assessment.

D. CALIBRATION OF A MARGIN ADJUSTMENT MECHANISM

The benefits of achieving SPTs and the consequences of not achieving them should be clearly defined in the legal documentation.

• Step-down/step-up principle :

An increase and decrease in margin should be provided in order to estimate the borrower's ESG risk variation in the credit margin spread.

• Ratchet and gradation levels :

- Any increase in the margin should be paid systematically to the debt holders.
- The margin adjustment should vary by market and sector, but also depending on the level of ambition of the company.
- The magnitude of the variation of the margin should be scaled according to the overall interest rate of the financing and the ambition of the ESG indicators.

An example of a mechanism based on three indicators and a total margin variation of 20 bps is given below for illustrative purposes :

Margin adjustement	Bps
KPI 1 achieved / not achieved	-7.5 / +7.5
KPI 2 achieved / not achieved	-7.5 / +7.5
KPI 3 achieved / not achieved	-5.0 / +5.0
3 KPI achieved / 0 KPI not achieved	-20 / +20

The rate variation can be adjusted according to the ambition or importance of the KPI

Core practices
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4. Reporting and Review

ESG transparency is a prerequisite for the development of sustainable finance markets. The legal documents should precisely define the company's commitments in terms of ESG information and reporting timeframe

- **Information undertakings**

ESG reporting undertakings included in the legal documents should include commitments to provide :

  - An ESG compliance certificate, signed by an officer of the company and audited by an independent third party (see section 3.B Parties). The certificate should contain (or be supplemented by) information that enables lenders to determine whether the company has met each SPT. A template of the certificate should be provided in the legal documentation (usually in an annex).
  - An annual ESG questionnaire including notably information regarding lenders regulatory requirements such as PAI. The questionnaire can be updated during the debt lifetime according to regulatory changes (a model questionnaire can be annexed to the legal documentation).
  - An annual update of the ESG strategy (which can be presented during the annual lenders' meeting) by means of an ESG report covering the information required by European or other local and international regulations. We suggest that borrowers produce reports using international standards such as TCFD or those from similar recognised bodies.
  - An annual carbon footprint assessment (scope 1, 2 and 3) alongside with a climate report prepared by an independent expert that explains how the borrower has met its climate challenges in terms of reduction targets, Capex and associated R&D...

- **Review of ESG information**

  - An independent third party should be appointed once a year to audit and validate information in the compliance certificate on the borrower's performance against each SPT.
  - The failure to obtain the ESG compliance certificate should trigger an event of default and the margin adjustment mechanism.

- **Rendez-vous clause and waiver request**

For any SPT to be defined at a later stage during the financing period or for any change in the KPIs or SPTs, the decision on the new KPIs or SPTs should be taken by a majority of debt holders (two-thirds). The change in the margin adjustment should be made subject to the unanimous consent of the lenders.

5. Other considerations

Debt holders will attach particular importance to the alignment of interests within the borrower, notably, by matching the KPIs used in the financing with the ones used for the variable remuneration of managers.

Debt holders stress the need for sufficient ESG information when analysing the investment opportunity during the financing period: an ESG report commissioned from an independent third party can help, as can a second party opinion on the selected KPI and SPT within the framework of the ESG-linked financing. The ambition and effort required to achieve the targets should be clearly demonstrated by the borrower to avoid dragging the market down, which would be contrary to the fiduciary duty that private debt investors owe to their own investors and would ultimately lead to a reduction in the liquidity available to the borrower. Financial intermediaries (banks, financial advisors) are also invited to make every effort to ensure that these ambitions are well understood and disseminated, by working with their borrowers. Debt holders will ensure that that there is a person or team in charge of ESG within the company, that there is dedicated governance of ESG decisions, and to assess the aims and credibility of borrowers' CSR strategy.

Core practices   Nice to have

ANNEX 1 : Glossary

Article 29 : Loi Energie Climat : French law regulating non-financial reporting for French companies.

CSR : Corporate Social Responsibility.

ESG : ESG refers to the Environmental, Social and Governance areas, which generally constitute the three pillars of extra-financial analysis.

ESG Coordinator : a financial institution appointed to act as an intermediary between the borrower and the investor(s) in order to facilitate the process of setting up Sustainability-linked financing, prior to investment.

GHG Protocol : Greenhouse Gas Protocol : establishes global standardized frameworks to measure and manage greenhouse gas (GHG) emissions from private and public sector operations, value chains and mitigation actions.

GRI : Global reporting Initiative : Standardisation body for the sustainable development performance of companies and organisations.

Key Performance Indicators (KPIs) : KPIs are quantifiable indicators used in the context of Sustainability-linked financing Corporate Social Responsibility (CSR): CSR makes companies accountable for their sustainable commitments in a qualitative way; ESG helps to measure or quantify these efforts.

PAI : Principal Adverse Impact : indicators included in SFDR regulation, allowing to assess negative effects in terms of sustainability.

Private debt : any debt provided by institutional investors, with legal documentation negotiated by the borrower, whether or not through an intermediary (bank or financial advisor), on a bilateral basis with an investor or with a limited number of institutional investors. Private debt generally includes the following instruments: Euro Private Placement, Corporate Lending, Senior Debt, Direct Lending, Real Estate, Asset Financing.

Scope 1, 2 and 3 : Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company. Scope 3 includes all other indirect emissions that occur in a company's value chain.

SFDR : Sustainable Finance Disclosure Regulation : European regulation on ESG transparency of investment funds.

Sustainable Performance Targets (SPTs) : SPTs are thresholds to be reached during the financing period for each defined KPI.

TCFD : The Task Force on Climate-Related Financial Disclosures sets out recommendations for the disclosure of information by companies to investors about their governance and actions to reduce their climate change risks.

Thanks

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