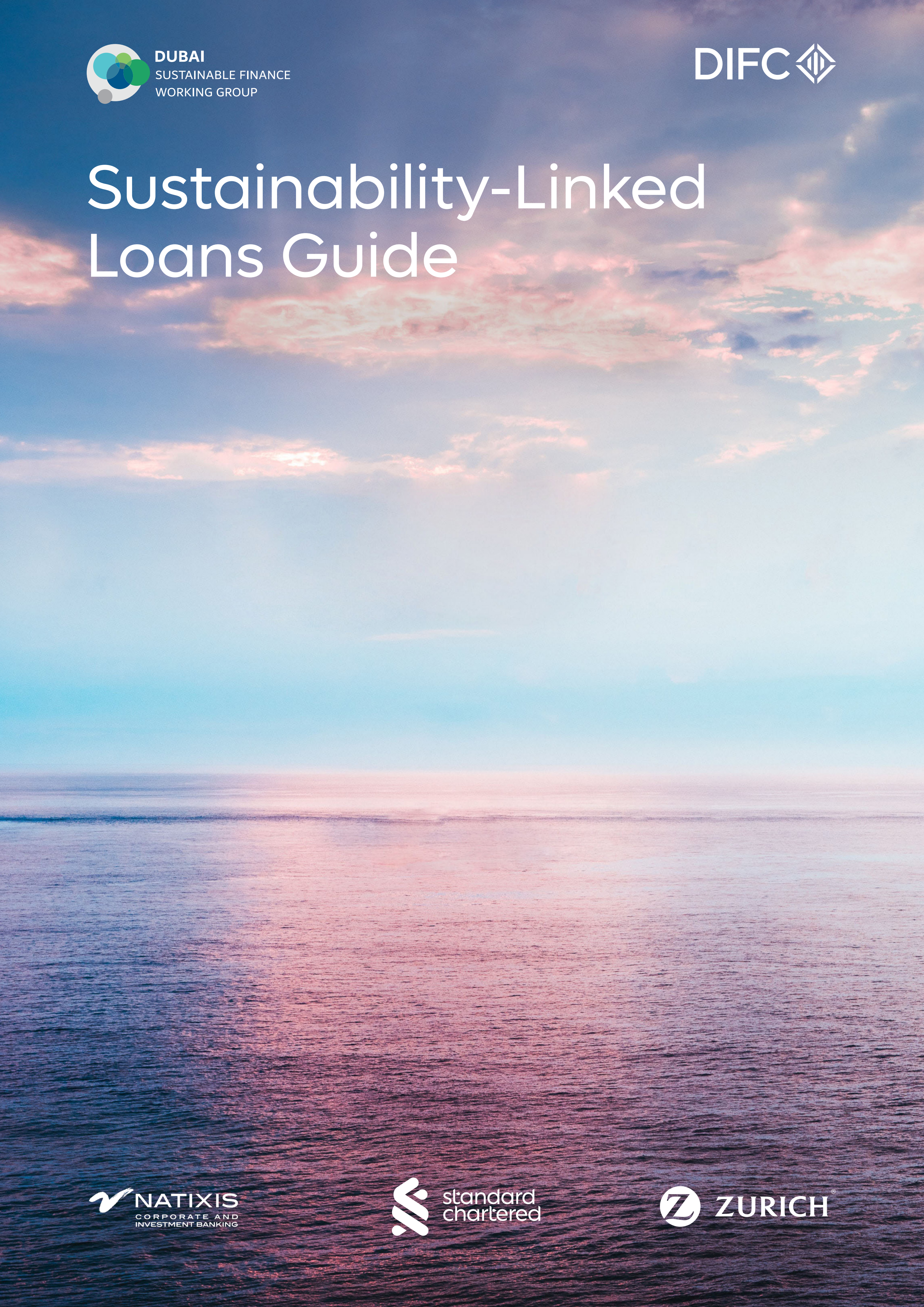
DUBAI
SUSTAINABLE FINANCE
WORKING GROUP

DIFC

Sustainability-Linked Loans Guide



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1. Introduction

Dubai Sustainable Finance Working Group

Launched in July 2019, the Dubai Sustainable Finance Working Group (DSFWG) was established to facilitate the Emirate's transition to the most sustainable financial hub in the Middle East, Africa and South Asia (MEASA) region. The Working Group focuses its efforts on four strategic pillars: Responsible Business Operations, Responsible Investing, Growing Sustainable Finance, and Gender Diversity and Inclusion.

Today, the Working Group is comprised of more than 30 active member institutions from across the public and private sectors with seven sub-working groups. The DSFWG has established itself as a key translator and change agent between high-level groups, in the United Arab Emirates (UAE) and globally, that focus on policy and national goals, and private and public sector entities committed to catalysing and actioning change for a sustainable future.

This guide is designed to provide an introduction to sustainability-linked loans and their growing importance in the Middle East and North Africa (MENA) region.

Sustainability-linked loans (SLL) are a type of financing in which the borrower's loan terms and pricing are linked to the achievement of specific sustainability goals. These loans are increasingly being used to fund projects that contribute to a more sustainable future.

The purpose of this guide is to increase the quality, transparency, and alignment of the MENA market with global best practises in sustainability-linked lending. It is intended to provide an overview of the key concepts and considerations involved in this type of financing, as well as to highlight the benefits and potential challenges of implementing sustainability-linked loans.

2. Trends driving sustainability in finance and insurance

The rationale for this guide is based on several key trends in finance and insurance that are driving sustainability. With growing awareness of the need to transition to a more sustainable future, financial institutions are under increasing pressure to support projects and initiatives that contribute to this transition. This includes both traditional financing options like green bonds and more recent innovations like sustainability-linked loans.

Investments

ESG investing grows and companies respond. ESG ETF's saw record inflows.

Debt Market

Green bonds and SLL's boost the sustainable debt market.

Economy

Transition to net-zero carbon economy.

Reporting

Mandatory ESG reporting for companies is either in force, planned or under discussion in many countries.

Climate Risk

Financial Institutions are stress-testing climate risk. Insurance is risk based Mitigating potential losses from social issues like human rights, or climate-related weather damage, i at the heart of insurance and re-insurance.

The UAE has established itself at the forefront of sustainable finance trends and best practices. It has the opportunity to lead the way in the adoption of sustainable finance as a hub for financial and business activity in the MENA region.
The UAE's sustainability-linked loan market is still in its infancy, which presents an opportunity to ensure that its financial sector is well positioned to support the transition to a more sustainable future by implementing best practices from the start. This can help to reduce the risk of greenwashing, which occurs when financial institutions make unsubstantiated or misleading claims about the sustainability of their products or activities.

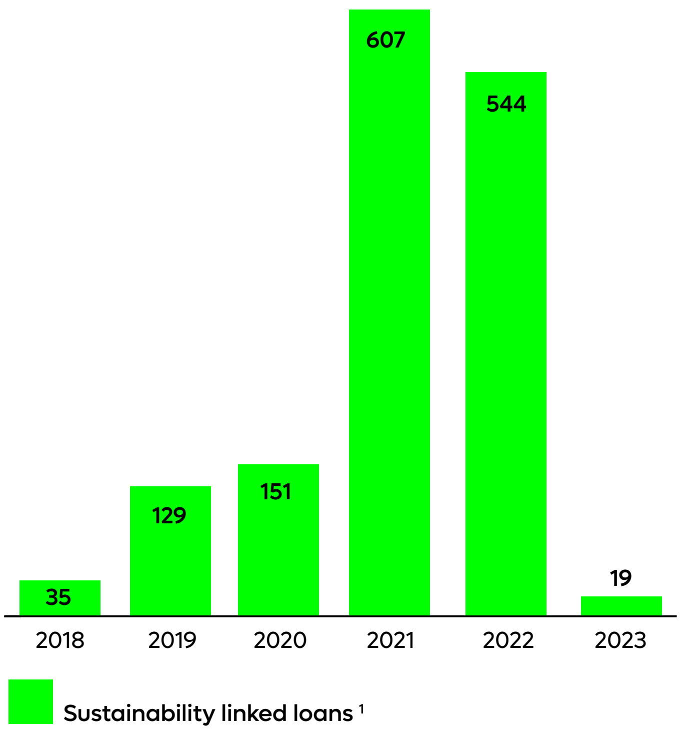
3. Overview of the SLL Market

Since the SLLPs were announced in March 2019, the SLL market has grown significantly as more and more borrowers take advantage of the format. However, there were some early SLLs before this date (often called green pricing loans, or similar) as well. The chart below shows the continuing increase in global volumes of SLLs over the last few years. Of course, 2020 needs to be looked at in the context of the Covid-19 pandemic, but overall there is a clear sign of increased and lasting interest in borrowing in this structure.

The Middle East has not adopted SLLs as quickly as some other parts of the world although there has been an acceleration since 2021. The first SLL in the region was signed in 2018, although at the time it was not called a SLL and instead was described as a "green" loan given that the SLLPs had not been published. This was a $2 billion "amend and extend" by DP World for its conventional and Murabaha revolving credit facilities and was also the first time where a loan in an Islamic format had pricing linked to environmental performance.

Since then, more borrowers have adopted the SLL format, with the UAE being the leading market in the region. In the UAE, the likes of Emirates NBD, Majid Al Futtaim, Landmark Group, Aldar, Etihad Airways and Metito have borrowed in SLL format. Elsewhere in the region there have been SLLs from Gulf International Bank, Alba, nogaholding, Ahli United Bank and Oman Shipping Company.

Issuance volume for SLL per year ($bn)



DP World	Emirates NBD	Majid al Futtaim	Landmark Group
In October 2018, DP World agreed the first sustainability-linked financing in the region in a USD 2 billion "amendment and extension" of an existing facility The transaction was structured so that the margin of the facility was linked to DP World's carbon emissions intensity The facility was also in an Islamic format, in another market first	In March 2021, Emirates NBD raised the first sustainability-linked loan for a UAE-based bank The USD 1.75 billion transaction was used to refinance existing debt and nearly 20 banks participated The KPIs were linked to gender diversity in top management roles and reducing water consumption	Majid al Futtaim has raised two sustainability-linked loans to date, starting with a USD 1.5 billion facility in August 2021 and following up with a USD 1.25 billion facility in December 2022 In 2021, MAF became the first regional borrower to have a "penalty only" SLL The KPIs were linked to reducing emissions intensity, obtaining green building certifications on malls and increasing gender diversity in management roles	In April 2022, Landmark became the first private sector company in the UAE to borrow in SLL format The KPIs included increasing consumption of renewable energy, waste recycling and gender diversity Landmark committed that any margin reductions from hitting its targets would be put back into its sustainability agenda

[1] Source: Dealogic as of March 3rd 2023

4. Theory behind SLL and SLLPs

A **Sustainability-Linked Loan** is defined as any type of general corporate use loan instrument which incentivizes a borrower to achieve ambitious and predetermined sustainability performance objectives. These objectives are measured using **Sustainability Performance Targets (SPTs)** which include **Key Performance Indicators (KPI)** that measure improvements in the borrower's sustainability profile over time.

To ensure the existence of a common market practice and to promote the development of SLLs, a set of voluntary guidelines framing Sustainability-linked loans, known as **Sustainability Linked Loan Principles (SLLP)** were established jointly by issuers, investors and environmental groups based on the most recent loan take outs and guidance from Asia Pacific Loan Market Association("APLMA")[2] , Loan Market Association ("LMA")[3] and Loan Syndication & Trading Association ("LSTA")[4]. In 2021 SLLPs were updated to be aligned with ICMA's Sustainability Linked Bond Principles. In addition to this, the language regarding KPIs and scope of SPTs were tightened to further promote the transparency and integrity of SLLs and the need for an independent, external verification of the borrower's performance level against each SPT for each KPI was made mandatory.

An updated version of the SLLPs and Guidance was published in February 2023[5] to reflect recent developments in the sustainable finance markets. This update highlights the importance of KPIs being material to the borrower's core sustainability and business strategy and addressing relevant ESG challenges of its industry sector; recommend that annual SPTs are set for each KPI for each year of the loan term; contain helpful updated guidance and clarification on verification reports and external reviewers.

When putting in place an SLL key factor that need to be taken into consideration include the **selection of KPIs, calibration of SPTs, Specific Loan Characteristics, Reporting and Verification**.

[2] aplma.com/
[3] lma.eu.com/
[4] lsta.org/
[5] https://www.lma.eu.com/sustainable-lending/documents

4. Theory behind SLL and SLLPs

4.1. Selection of KPIs

KPIs selected must embody four characteristics: firstly, they must be **relevant, core, and material** representing strategic significance to the borrower's current or future operations ; secondly, they should be **measurable and quantifiable** using a consistent methodological approach; thirdly, to the extent possible KPIs should be **benchmarkable** using external references or definitions to facilitate the assessment of the SPT's level of ambition and finally indicators are required to be **externally verifiable** and auditable, or already audited as part of the registration document or equivalent.

KPIs must be holistic enough to encompass the overall evolving picture of the company while simultaneously being controllable by the borrower and comparable with relevant baselines. Thus, at **Minimum 1 KPI** is recommended for simplicity purposes assuming that the sole KPI is sufficient or a **Basket of 2 to 3 KPIs** can be used to aid in reflecting company's holistic transition/carbon footprint (no more than 4 KPIs in any case).

In the majority of cases, Carbon emissions are the most material sustainability topic for borrowers, the below considerations will help guide KPI selections for GHG emission reductions.

(i) A **KPI related to Scope 3 GHG emissions** must be present, as advised by SBTi, if it represents more than 40% of the entire carbon footprint of the issuer in order to produce a best-in-class Framework. If no target is available in the short term for this KPI, it can be complemented with a proxy (e.g., 'renewable installed capacity expressed in GW'). When it comes to other sustainability topics, same life cycle and value chain approach should be considered to select the KPIs

(ii) **Absolute Targets** are strongly recommended given they are in line with bet market practice however, Intensity/relative targets are acceptable if supported by a strong net-zero strategy and pathway with detailed levers activated to achieve such strategy. Intensity allows easier benchmarking exercise with peers, as far as the denominator is well selected with physical intensity (instead of economic intensity)[6] and disclosure on absolute emissions is available. These two approaches can be combined

(iii) **Emissions Reduction Approach as Opposed To an Offsetting Approach** to ensure focus on decarbonization as much as possible with the use offsetting as last resort. Offsetting could be added to neutralize a very limited amount (<10% as recommended by SBTi) of residual emissions. In any case, transparency is of the essence here and the intended portion of reduction versus offsetting should be disclosed in the framework

[6] For example, physical intensity metrics are based on "tonnes GHG per tonne product" or "MWh generated" while economic intensity metrics are based on "tonners GHG per unit value-added"

4. Theory behind SLL and SLLPs

4.2. Calibration of SPTs

SPTs that are considered robust and ambitious demonstrate **the Company's Performance** by portraying the material improvement in KPIs beyond the business' usual trajectory and/or historical data, are **Benchmarkable** against both peers/sectoral data and science-based scenario and/or international standards or baselines and are **Consistent with Overall Strategic Sustainability Planning.**

The main recommendations when calibrating include:

(i) **Ensuring Long Term Visibility** is available even if such ambition is not an active target per say in the sustainability-linked loan mechanism

(ii) **Setting Intermediate Targets** i.e., Every 5 years is recommended to show credibility in the pathway toward the final target **that are benchmarkable** with peers on global targets and intermediary milestones. The pace can increase in remote periods (for instance the full details of the reduction levers for the 2040 to 2050 period are unlikely to be known today as it may rely on unmature technologies)

(iii) To the extent possible **Aligning with Market Practices** and objectives set up by international organizations with science-based targets. Examples include Science Based Targets initiative ("SBTi")[7], International Energy Agency ("IEA")[8] and Transition Pathway Initiative ("TPI")[9]. For instance, the International Energy Agency (IEA) and Science-Based Targets initiative (SBTi) reference trajectories are available and in use for the following sectors: electricity, oil & gas, real estate, transport, telecoms and heating networks.. This must be done while simultaneously **Maintaining Transparency on the Accounting & Target-Setting Approach/ Methodologies**

(iv) A **"Rendez-Vous Clause"** pre-determined at issuance to cover any case of necessary KPI or target adjustment including for instance a change of perimeter (acquisition of new business unit(s),…) or define Sustainability-Performance Target(s) beyond end of current Sustainability Strategy at later stage. A **Potential Impact Of Target Achievement** depending on the acquisition/ divestment and on the type of KPI/target (absolute vs. intensity), as well as **Disclosure and Reporting** to lenders in case of recalculation

Setting ambitious SPTs is an important part of the process, ensuring this can be done by:

(i) Including a provision in the loan documentation that requires the SPTs never be lower than any publicly announced targets. If a borrower therefore publicly announces more ambitious targets during the life of the loan, the SPTs will be amended to reflect this. This ensures that the SLL continues to be true to the core principle of ambition for the entire tenor of the loan. In addition, SPTs should be seen to go beyond regulatory requirements and indeed be set beyond performance targets already achieved by the borrower, unless there is a clear rationale for exception in these instances.

(ii) The SLL can make long term targets viable via the setting of short term SPTs. These short-term milestones will act as a useful tool to focus a borrower's mind in achieving any long-term sustainability targets and hold them accountable to any publicly announced targets.

(iii) When setting SPTs that represent a 'true reach', failure might occur. Faliure to achieve SPTs is built into the loan documentation, often via the incentives mechanic, and is therefore catered for. What should not be encouraged is "sustainability á la carte", i.e. the ability to declassify and reclassify the deal as a SLL depending on whether the borrower is meeting its targets at any point in time. This greatly undermines the integrity of the market.

[7] sciencebasedtargets.org/
[8] iea.org/
[9] transitionpathwayinitiative.org

4. Theory behind SLL and SLLPs

4.3. Specific Loan Characteristics

The **Financial characteristic** of a loan **varies depending on whether the selected KPI(s) reach** (or not) **predefined SPT(s)**. A **Yearly variation of the margin** is the **most common mechanism.** The **Variation** of financial characteristics **should be commensurate and meaningful relative to original financial characteristics** of instrument(s).

There are two mechanisms in which the margin adjustment is tied to the number of selected KPIs that have been reached:

(i) In the case of multiple KPI's being selected a **Combined Results Approach** in which an initial margin is determined and based on the collective achievement of the KPIs the margin will vary
(ii) **Individual Results Approach** each KPI results in a bonus/malus level that will be added to the others (a combination of both can be used)

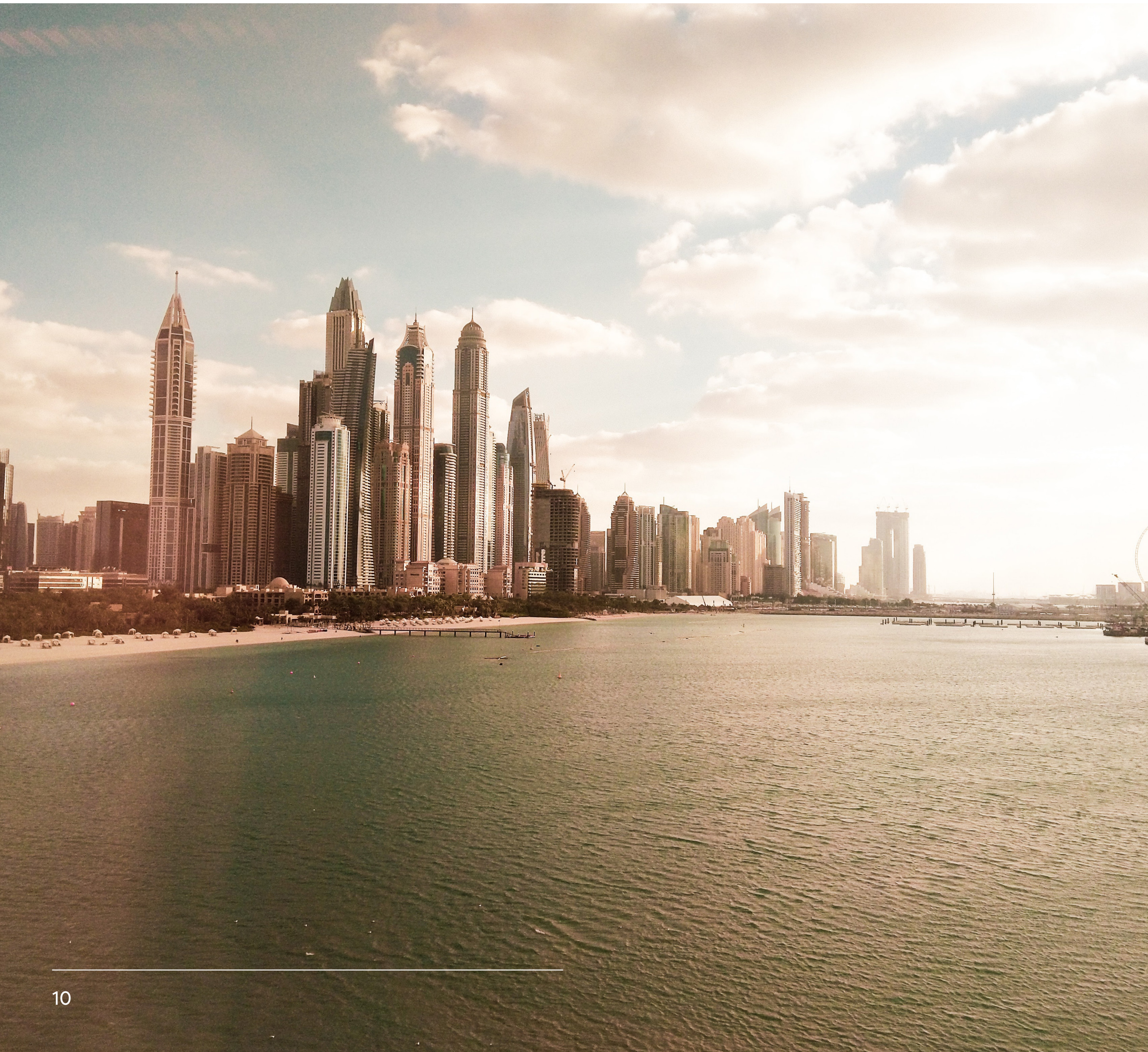
It is recommended to apply a level of margin adjustment in line with market practices i.e., c. 5% of the base margin. The margin adjustment mechanism should be balanced between increase & decrease scenarios (and neutral scenarios, if any)

Allocation of premium / discount: Premium / Discount in most cases directly impacts lenders or treasury depending on annual margin impact observed. Optionally Premium / Discount applied to margin can be directed to internal or external initiatives and projects supporting sustainability strategy in "step up efforts approach" instead of lenders or treasury depending on annual margin impact. Demonstration of additionality in support to internal/external initiatives targeted is key. Optional feature is far from being systematically implemented and in any case not mandatory

4. Theory behind SLL and SLLPs

4.4. Reporting

A Sustainability KPI Report (detailed below) must be **published to lenders at least annually** with:
(i) **up-to-date information** on performance of selected KPI(s), including baselines where relevant
(ii) any **information enabling lenders to monitor** level of ambition of SPTs
(iii) **verification assurance report** relative to SPTs outlining performance against SPTs



4. Theory behind SLL and SLLPs

4.5.Verification

An **independent and external verification** of performance level against each SPT for each KPI by qualified external reviewer with relevant expertise (an auditor or an environmental consultant) must be completed at least once a year. This verification of performance against the SPTs **should be made available to all Lenders** (via agent). **Post-signing verification** is a necessary element of the SLLP as opposed to the pre-signing external review such as SPO which is recommended only.

In summary the main considerations when putting in place sustainability linked financing include:

(i) The borrower mandates a **Sustainability Coordinator to act as an advisor** in accordance with the most updated version of SLLP published by the Loan Market Association (LMA) available at the time.

(ii) **Sustainability KPI's** (defined above) would be selected and provided an (i) **Initial Score** i.e., starting point values at inception of the facility (ii) **Target Score** i.e., range of values (iii) **Achieved Score** i.e. the number assigned to that KPI with respect to the relevant calendar year. These form a part of the **Sustainability Performance Programme** which represents the Borrower's selected KPIs and Targets and their efforts to meet the Target Score of each and every KPI. **All the above is documented and reported in a Sustainability KPI Report** which is subjected to an independent audit (alongside the company's Corporate Social Responsibility Report of the Universal Registration document) by a **Sustainability Auditor**

(iii) A **Sustainability Linked Margin Adjustment** is agreed and put in place, thus from the first day of the Interest Period during which is delivered to the Facility Agent until the date of delivery of the next Sustainability KPI Report the Interest Rate will be adjusted by following the agreed Sustainability Margin Adjustment

(iv) **Covenants** regarding the timeliness, scope and auditing of the sustainability report, as well as, adherence to rendez-vous clause are included in facility documentation.

5. Challenges of SLLs

For many borrowers, a debut SLL can be a daunting task and there are often a few key challenges that are expected as well as some others which appear along the way. By being wise to these challenges from an early stage, and thinking of means to deal with them, borrowers are able to streamline the process. The Sustainability Coordinator(s) play a key role in helping borrowers to navigate these challenges and ensure the deal is a success.

Choosing KPIs – this is the most crucial part of any transaction as without the right KPIs, there is nothing to build upon. Borrowers should follow the guidance set out in the SLLPs, and this guide, to ensure that they choose credible KPIs. But it is also important to think about KPIs that make sense for the company itself. One key thing to consider is the availability of data and whether it is easy to report on the required information. It may be that for a debut SLL, some of the KPIs the borrower considers are not possible given as there is insufficient confidence in the data accuracy. To counter this, where possible it is worth looking at metrics that have already been reported for several years or leaving sufficient time to test the reporting process

Agreeing to Targets – while the importance of setting ambitious targets has already been described and is a key requirement of the SLLPs, borrowers often face challenges in getting senior management to agree to link targets to financing through a SLL. There is sometimes also a concern that if targets are not already incorporated into scorecards to ensure that there is sufficient internal alignment on making the progress needed to deliver on them. Borrowers can look to targets that have already been committed to in order to mitigate this challenge, but if introducing new targets, getting senior management buy in from an early stage on the importance of the facility being a SLL is important

Communicating the SLL Features to Lenders – an often overlooked part of a SLL is the importance of having a really strong narrative around why the KPIs have been chosen, why the targets are ambitious and how it fits into the borrower's overall sustainability strategy. As lenders increase their focus on sustainable finance, they are also increasing the sophistication of their internal ESG approval processes and this means that the more information they can access to make the assessment that the facility is no "greenwashing", the better it will be. By clearly presenting the information, potentially in a dedicated SLL presentation, borrowers can ensure that lenders get comfortable quickly and there are no delays to approval processes. The Sustainability Coordinator(s) can help to prepare the presentation and then answer any resulting questions

Selling the SLL Internally – building on the challenges described in agreeing to targets, it can often be tricky to get internal interest in a SLL outside of senior management or the finance team, when it is the operational or business teams that are likely key in achieving the targets of the SLL. Demonstrating that reaching these targets will lead to a saving can play a key role, but some borrowers have taken this further and have made clear commitments to use margin savings to fund ESG activities across the company to help further incentivize

Following up with the Second SLL – an important part of the sustainable finance market is that each year the standards evolve while not meaning that previous years are unduly judged. However, this does mean that if a borrower does a SLL one year, they may have to look at the structure the next year to check if it is fit for purpose. For a borrower looking to be a regular SLL borrower, it would make sense to look to continue to develop the SLL structure, ensuring that targets make sense in light of recent performance or considering new KPIs which maybe were not suitable for earlier transactions

6. Disclaimer

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