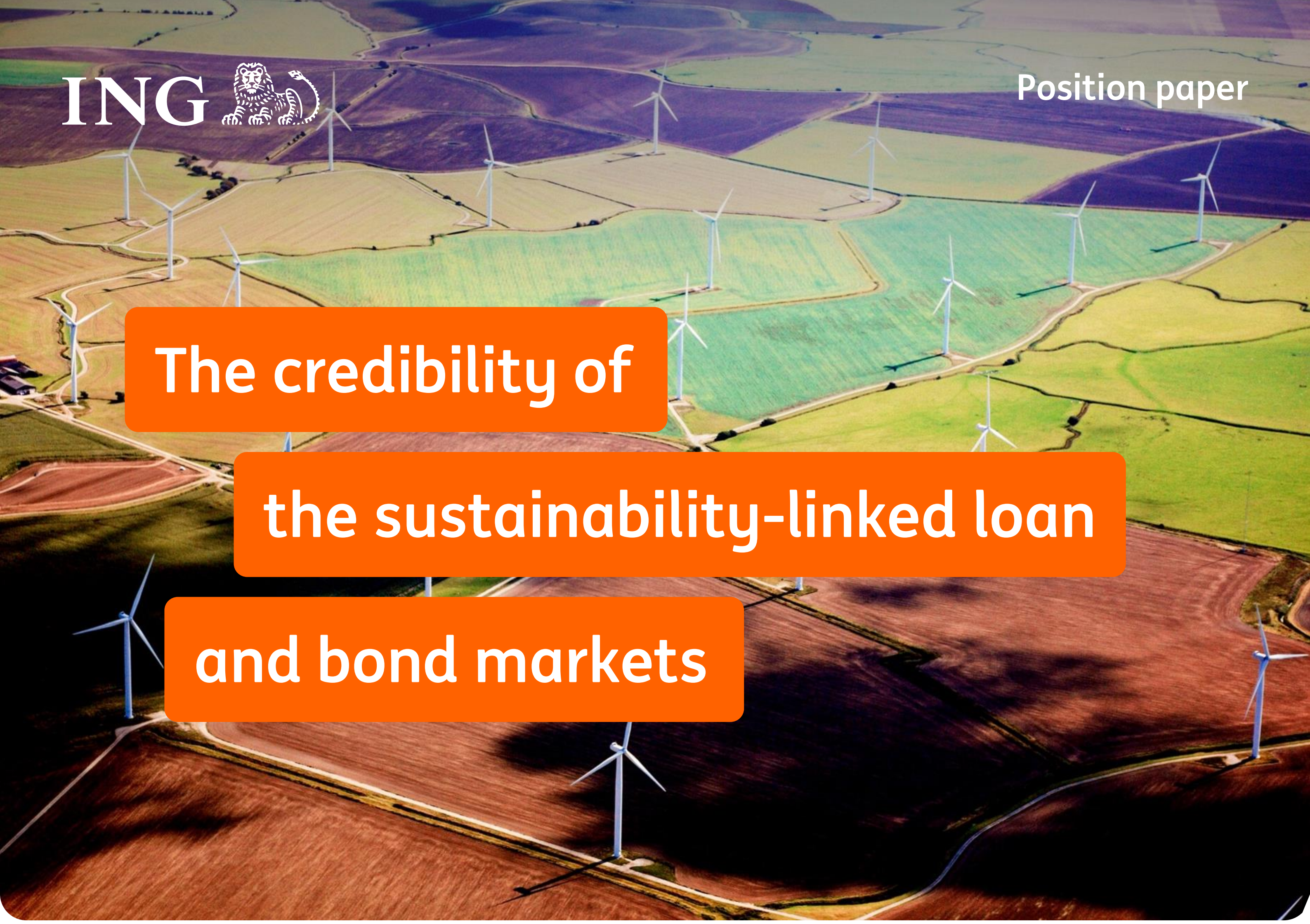

Position paper

The credibility of the sustainability-linked loan and bond markets

"It's our joint responsibility to uphold the sustainable finance market to realise the significant efforts needed to transition to a sustainable economy."

Andrew Bester
Head of Wholesale Banking

ING strongly supports the Sustainability-Linked Loan Principles and Sustainability-Linked Bond Principles. As the architect and initiator of sustainability-linked financial products, ING views it important to maintain the credibility of the sustainability-linked loan and bond markets. We, therefore, consider the publication of this paper as an opportunity to thoroughly review and, where necessary, recalibrate our own views and internal standards regarding sustainability-linked products. Based on our conviction that sustainability is a core value driver we consider the following elements important when further evolving this market towards supporting a sustainable economy:

- Sustainability KPIs have to address a company's **material sustainability issues**.
- Sustainability targets must be **ambitious**, industry-wide, based on best efforts and (wherever possible) verified by a reputable**, independent party**.
- Sustainability strategies must tackle the **most pressing problems first.**
- As a credible sustainability strategy aligns increasingly with credit risk, discounts and premiums are part of a bank's business model and we would be **reluctant for them to go to charity.**

In May 2021, the global loan market associations[1] released the revised version of the Sustainability-Linked Loan Principles (SLLP), which aligns it with the Sustainability-Linked Bond Principles (SLBP) as published by the ICMA in June 2020.[2] ING considers these new versions a further improvement and strengthening of the principles underlying sustainability-linked financial products. In relation to both sets of principles, in this paper we'd like to reflect on recent market developments. We believe these developments are not sufficiently supporting our efforts needed to meet the UN Sustainable Development Goals (SDGs). Specifically, we discuss KPIs that don't reflect the material sustainability issues a company faces; ambition levels that are questionable; difficult issues being pushed into the future; and discounts and premiums being donated to charity.

We believe it's in the interest of all market parties to safeguard the credibility of the sustainable finance market. The purpose of the principles is to promote sustainable development in general. Market parties should voluntarily do their best efforts to preserve the integrity of sustainability-linked financial products, for example in line with the goals of the Paris Agreement[3]. Sustainability-linked financial products are a tool that help companies to accelerate the transition to a sustainable economy, by incentivising companies to reach ambitious, predefined sustainability performance objectives.

We realise that the road towards a sustainable economy is not without bumps, and that everyone learns along the way.

1. A credible sustainability strategy addresses a company's material sustainability issues.

We consider sustainable development an all-encompassing concept as it has been formulated by the UN in its original report 'Our Common Future' (1987) and adopted during the Earth Summit in Rio de Janeiro (1992). Since then, sustainable development has been worked out in the UN Sustainable Development Goals (SDGs), which were adopted in 2015. Sustainability means that we cannot focus on one goal, for example, mitigating climate change, while neglecting other goals like, for example, famine relief. The UN 2030 Agenda for Sustainable Development[4] is about realising all 17 SDGs, not just a subset. The SDGs mutually depend on each other. To preserve the planet for future generations the full UN sustainable development agenda must be realised during this decade of action, 2020-2030.

Having said that, we are aware that no company can realise all the SDGs on its own. Some sustainability issues matter more to a business than others. For example, a company's business processes may be more related to clean water and sanitation (SDG 6), whereas another company's business processes could be strongly related to industry, innovation, and infrastructure (SDG 9). To find out which sustainability issues matter most to specific industry sectors, the Sustainability Accounting Standards Board (SASB) has published its Materiality Map. The SASB table specifies, for example, that circular economy in the sense of achieving zero waste in production plants matters most to one industry sector, whereas employee health and safety matters most to another sector.[5] The Global Reporting Initiative defines: "material are those topics that have a direct or indirect impact on an organisation's ability to create, preserve or erode economic, environmental and social value for itself, its stakeholders and society at large."[6] By combining this with the SASB Materiality Map, it follows that companies across all industry sectors deal with at least 3 to 10 material sustainability issues.

Given the all-encompassing nature of sustainable development, the above means that a company's sustainability strategy can be called credible once it addresses the significant material sustainability issues that the company faces. Making our best effort to bring sustainable development further means that our strategies must tackle the material sustainability issues inherent to our business processes. We should do substantially more than solving the 'easy' issues, or the ones that might not even be material. Consequently, when playing a significant role in a sustainability-linked loan transaction (e.g., as sustainability coordinator, documentation agent or bookrunner), ING typically promotes tackling a minimum of three material sustainability issues with respective KPIs. Where possible, and when the industry's materiality matrix so prescribes, more KPIs related to material sustainability issues should be added. For bonds, we follow the SLBP.

2. A credible sustainability strategy sets ambitious sustainability targets.

Despite stronger efforts worldwide to act on the SDGs, concerns voiced by scientists that we're not doing enough are becoming louder. The IPCC 6th Assessment Report, released on 9 August 2021, expresses these concerns more explicitly than ever before. This means that, while we focus on the material sustainability issues of companies, an important question is: which sustainability targets can be considered ambitious? As said, global business is crucially important to bring the SDGs further; governments and individual citizens cannot do this alone. All players in the world economy face the herculean task to address climate change and realise a sustainable economy that is resilient in the

[1] APLMA, LMA and LSTA
[2] As an active member of the APLMA, LMA, LSTA and ICMA, ING has contributed to the SLLP and SLBP. For more information on the updated SLLP: https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/
[3] ING has joined the Net-Zero Banking Alliance in support of achieving a world with net-zero greenhouse gas emissions by 2050
[4] https://sdgs.un.org/2030agenda
[5] https://www.sasb.org/standards/materiality-map/
[6] https://www.globalreporting.org/

future. Thus, it is a must that all players in the economy take their responsibility to make a resilient economy happen.

Taking significant steps beyond business-as-usual means setting ambitious targets for tackling material sustainability issues by stretching oneself and the company. Being ambitious on material sustainability issues means that companies and their representatives do their utmost in good faith to execute all reasonable courses of action required to solve the issue.

However, for many of us, committing oneself to an ambition reveals another risk: self-certification or self-approval. The credibility of defining a sustainability strategy without external review may be questioned. To mitigate this risk in setting target levels for sustainability KPIs, the SLLP and SLBP strongly recommend referring to authoritative, independent sources of sustainability pathways like, the Science-Based Target Initiative (SBTi)[7], or the Transition Pathway Initiative[8]. In addition, credibility is gained if one can show that if all businesses in the company's industry sector would set the same target, the entire sector would be in line with the goals of the Paris Climate Agreement, for example, as provided by the SBTi or the International Energy Agency (IEA).[9] These independent bodies set clear transition pathways for companies and form a solid basis for a sustainability-linked financing structure. Finally, in line with the SLLP and SLBP, ING strongly recommends letting target levels for sustainability KPIs be verified by a reputable second party opinion (SPO) provider.

3. A credible sustainability strategy means taking action now, not later.

A recent report from Cambridge University highlights the challenges of the behavioural change that is required for attaining the goals of the Paris Agreement.[10] Significant steps are urgently required to make our food, transport, and energy habits more sustainable. We should see, for example, linearly decreasing greenhouse gas emission reduction pathways linked to an abatement curve and corresponding investment plan, or linearly increasing recycling rates for waste. Even better, we would like to see companies taking the most difficult actions first.

At the same time, we acknowledge that the financing calendar of companies may not always match with their strategic review timetable. The moment of reviewing the company's sustainability strategy may fall in the middle of the tenor of the loan to be linked to the sustainability KPIs. Therefore, we understand that companies would like to include certain provisions in SLL documentation to enable them to include the sustainability KPIs more easily later. However, staying true to the SLLP, when structuring a SLL with KPIs that will be set after the signing date, a robust process should be in place to ensure the quality of the KPIs including agreement with the lenders. Only when the entire framework has been implemented in loan documentation and is activated, it can be communicated in public.

4. A credible sustainability strategy is not a nice to have, it's a must.

Recently, we have seen a few SLL transactions where the discount and/or premium on the interest margin were donated to a charity. We would be reluctant to promote this practise for the following reasons.

First, a bank's business model by regulation is based on risk and reward, which means that low risks can be priced modestly, whereas higher risks require a higher price. Sustainability is integrated in everything we do. Since it is becoming clearer every day that the sustainability domain and the credit risk domain are getting closer to each other, companies without a credible sustainability strategy mean a higher credit risk to lenders.[11] Therefore, being asked to donate the premium to compensate for the higher credit risk is something we deem misaligned with the business model that banks operate. Lenders also don't do this when applying usual margin ratchets.[12]

Second, instead of aligning the loan market and the bond market around the sustainability-linked feature, the charity mechanism leads to divergence of these markets. We consider this confusing for the market parties involved.

Third, the reporting of these donations is not transparent. ING reports about its economic value generated and distributed from operations towards different stakeholder groups (suppliers, employees, shareholders, governments, and community).[13] The donations to charities, as we see them in a few deals, do not show up in reporting. In addition, drafting a separate report for these donations, like for the purpose of tax reporting, is cumbersome and does not contribute to making a sustainability impact.

7 https://sciencebasedtargets.org/
8 https://www.transitionpathwayinitiative.org/
9 https://www.iea.org/reports/net-zero-by-2050
10 https://www.rapidtransition.org/wp-content/uploads/2021/04/Cambridge-Sustainability-Commission-on-Scaling-behaviour-change-report.pdf
11 S&P states: "ESG credit factors are those ESG factors that can materially influence the creditworthiness of a rated entity or issue and for which we have sufficient visibility and certainty to include in our credit rating analysis." For more information: https://www.spglobal.com/ratings/en/products-benefits/products/esg-in-credit-ratings
12 A mechanism whereby the initial margin is reduced as and when the borrower receives a better financial position, commonly used in a loan facility.
13 ING Group, Annual Report 2020, p. 421

Conclusion

In this position paper, we've reflected on a few recent developments in the sustainable finance market. As the architect and initiator of banking products that link the sustainability achievements of clients to the price of these products, ING is concerned about the credibility of this market. Given the enormous growth of the market for sustainability-linked financial products and their potential for helping to make the real economy more sustainable, we consider it our responsibility to be clear on where we stand on the risks of being satisfied with realising too few, not very ambitious sustainability KPIs at some point in the distant future. We expect that borrowers and lenders in this market will share this responsibility to maintain the integrity of the sustainability-linked financial products. In summary, sustainability KPIs must address a company's material sustainability issues; sustainability targets must be ambitious and based on best efforts, and wherever possible verified by a reputable, independent party; sustainability strategies must tackle the most difficult problems first; and discounts and premiums should not go to charity, since it is our joint responsibility to uphold the sustainable finance market to realise the significant efforts needed to transition to a sustainable economy.

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