



From ratchet to reality

Closing the execution and materiality gap
in sustainability-linked margin ratchets

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dss⁺

Protect. Transform. Sustain.

Executive summary

Sustainability-linked margin ratchets (SLMRs) have evolved from an early 2020's boom into an enduring feature of private credit. However, as the market has matured, a deeper issue has emerged: many SLMRs exist in principle but are not implemented in practice.

While ratchets are now widely included in term sheets, this often reflects optionality rather than execution. KPIs are frequently finalised late, deferred, or never activated. Even where they are agreed, many lack materiality to the borrower's business, limiting their ability to drive meaningful behaviour change or strengthen credit quality.

This matters because private credit managers often have limited influence over borrower behaviour. SLMRs provide a practical way to link pricing to performance and reward progress, while supporting risk management, sponsor relationships, and fundraising with LPs. For sponsors and borrowers, they offer a route to lower financing costs while signalling disciplined sustainability management.

The defining challenge is therefore closing two gaps: between inclusion and activation, and between ambition and materiality. This requires clear internal ownership, credible KPI design, robust data, and early alignment across sponsors, co-lenders, and verifiers.

This paper sets out a practical roadmap to close these gaps and turn SLMRs from term sheet features into credible, decision useful pricing mechanisms.

The ratchet is tightening

Sustainability-linked margin ratchets (SLMRs)¹ had their moment in the spotlight. Welcomed as a clever way to link sustainability performance to pricing by rewarding borrowers for meeting sustainability targets and giving lenders a visible proof point of ESG integration, they quickly became the mid-market darling of private credit.

That initial 2021-2022 boom was followed by growing scrutiny. At its peak, ESG-linked structures accounted for roughly 50% of European direct lending issuance in 2021², reflecting how rapidly sustainability-linked pricing mechanisms were adopted across the market. LPs, regulators, and the media began to call out weak structures, vague KPIs, and claims of sustainability outcomes that did not hold up under pressure.³ Some of those greenwashing accusations were justified: many ratchets lacked ambition, measurability, or meaningful consequences.

In response, some GPs quietly dropped the idea, citing complexity or cost, while others doubled down. However, the idea was not abandoned, but rather continued to be refined by a number of firms who were committed to credible SLMRs. Market data suggests that this group of lenders has become increasingly influential: the five most active European direct lenders accounted for roughly 55.9% of ESG-linked lending activity in 2025³, according to Debtwire rankings. Rather than focusing on selling the merit of the concept, they worked to refine SLMRs. They developed clearer frameworks, strengthened governance, and coordinated earlier with sponsors, borrowers, co-lenders and verifiers. The focus shifted

What are Sustainability-Linked Margin Ratchets (SLMRs)?

A quick primer

SLMRs are loan features that adjust the applicable interest margin based on a borrower's performance against material sustainability KPIs.

Margins typically decrease if predefined ESG targets are achieved and may remain flat or increase if they are missed.

Unlike sustainability-linked loans (SLLs) - which are explicitly structured around sustainability objectives from inception - SLMRs are usually **added onto standard credit facilities** as a pricing mechanism. They do not change the purpose of the loan itself but create an incentive for the borrower to improve performance on financially material ESG topics.

In private credit, SLMRs give lenders a practical way to reward sustainability progress even without control rights or board seats.

from marketing to meaning, using SLMRs as a genuine tool for engagement and sustainability progress rather than "ESG window dressing."

While headline adoption has fallen, more recent reported uptake figures tell only part of the story. Across the market, many lenders now regularly include ESG or sustainability-linked ratchets in their term sheets, with portfolio coverage rates often cited between 60–80%.⁴ Yet inclusion in term sheets does not always mean follow-through. In practice, some ratchets remain symbolic, with KPIs finalised late or never formally activated, limiting their actual impact.

SLMRs are increasingly being used as a behavioural tool to influence borrower conduct, strengthen risk management, and meet investor expectations. What matters now is not how many loans reference a ratchet, but how many follow through with credible, measurable implementation. When designed thoughtfully, SLMRs move beyond symbolism to become mechanisms that drive genuine sustainability progress and unlock tangible value for both lenders and sponsors.

1. While terms like sustainability-linked loans (SLLs), ESG-linked loans, and ESG margin ratchets are often used interchangeably, we use Sustainability-Linked Margin Ratchets (SLMRs) in this piece to emphasise the pricing feature, not to imply that the entire loan is structured as a formal sustainability-linked loan. In practice, SLMRs are most often layered onto standard credit facilities rather than defining them. The underlying loan would likely be agreed regardless, with the sustainability-linked margin adjustment negotiated and finalised - if at all - after closing. This distinction matters. While SLLs are designed from the outset to channel capital toward sustainability objectives, SLMRs are primarily a behavioural incentive: a pragmatic way for credit managers to encourage progress on material ESG topics within the bounds of conventional lending structures.

2. https://ionanalytics.com/insights/debtwire/european-direct-lending-market-shatters-records-for-deployment-deal-activity-in-2025-full-year-2025-european-direct-lender-rankings/?utm_content=rankings&utm_source=linkedin&utm_medium=organic+social&utm_campaign=analytics+debtwire+content

3. <https://www.fca.org.uk/publication/correspondence/sll-letter-june-2023.pdf>

4. <https://www.clearwatercf.com/assets/Insights/Debt-Advisory/Clearwater-Debt-Advisory-2025-Lender-Survey.pdf>

Example:

Mid-market industrials borrower

KPI selection and weightings are designed to reflect financial materiality, rather than treating all sustainability outcomes as equivalent.

KPI	Target type	Margin adjustment
Scope 1 & 2 GHG emissions intensity	≥5% YoY reduction vs. prior year	±10 bps
Share of recycled input materials	≥40% by year three	±7.5 bps
Lost-Time Injury Frequency Rate (LTIFR)	≥10% YoY reduction vs. prior year	±5 bps

Target missed
▲ +bps

Neutral
0

Target met
▼ -bps

Applied per KPI | Assessed annually | Maximum swing ±22.5bps

The practical upside of credible SLMRs for private market players

As SLMRs mature from concept to common practice, their value is becoming clearer. When designed well, they align financial and sustainability performance in ways that strengthen both credit quality and relationships across the deal chain.

For private credit lenders

- Gives lenders a **practical way to influence borrower behaviour** without taking equity control
- Links pricing to sustainability performance in a way that **supports risk management and credit quality**
- Provides a **clear signal to LPs** that ESG is built into deal terms, not handled separately
- Can make lenders **more attractive partners for sponsors**, supporting relationships and repeat deal flow in competitive processes

For private equity sponsors

- Helps portfolio companies **reduce financing costs**, freeing up capital for investment and growth
- Reinforces **disciplined sustainability management** that supports long-term value creation
- Shows LPs that **ESG is integrated into financial strategy**, not just portfolio operations

In tighter credit markets, where borrowers are facing tougher conditions when raising capital, ESG-linked terms can act as a differentiator. They can help borrowers access more attractive pricing, while reinforcing the lender's credibility with investors and co-lenders alike.

With rising scrutiny on pricing terms and the credibility of sustainability commitments, and with every basis point under pressure, SLMRs are emerging as a hallmark of thoughtful, modern credit structuring. The challenge now is to ensure they represent real substance, not just signalling, and that firms know how to manage them well.

In this context, private credit firms are not just passive participants in SLMRs. They are increasingly shaping the terms, expectations and outcomes. This position requires both strategic thinking and strong internal governance.

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From leader to gatekeeper

Private credit firms take different roles in SLMR negotiations

In practice, private credit firms rarely wear just one hat when it comes to sustainability-linked margin ratchets.



Sometimes, our clients are in the driving seat.

They originate the SLMR, propose KPIs and targets, and shape the structure based on their internal framework.



Other times, our clients are the gatekeeper.

They review terms proposed by a sponsor or co-lender, and decide whether they are robust enough to endorse, challenge, or decline.

Both roles carry weight: one sets the ambition, the other safeguards integrity. Either way, credibility is on the line.

To succeed, credit managers need the knowledge, tools, and confidence to propose KPIs that are material and defensible, and hold the line under scrutiny from borrowers, co-lenders, and the in-house Investment Committee. They also need the fluency to interrogate others' structures, benchmark ambition, and spot weaknesses without stalling the deal.

Most private credit firms are somewhere along this journey. In reality, many can perform one role but not the other. The good news: the barriers are common and increasingly solvable, but they must be tackled head on.



Closing the gaps

What holds firms back from credible SLMRs

Despite growing experience, many private credit firms face recurring barriers when translating ambition into credible SLMRs. The five gaps below appear most often in our work and help explain where well-intended SLMRs lose momentum in practice.

Ownership and accountability **Everyone wants the ratchet. No one owns the wrench.**

Responsibility for SLMRs sits across ESG and deal teams, with no clear owner pre and post-signing.

Why it matters

Without ownership, ratchets lose momentum and quickly become symbolic, creating credibility risk with LPs and co-lenders.

What good looks like

Clear accountability for SLMRs built into the investment process.

Capability **Deal teams hold the spanner, but not the manual.**

Deal teams are asked to agree KPIs without enough guidance on what is material or realistic to track.

Why it matters

This leads to weak or inconsistent KPIs that undermine the integrity of pricing decisions.

What good looks like

Deal-ready guidance that supports consistent decisions on KPI materiality.

Data **Without facts, it is just theatre.**

ESG data is often inconsistent and largely self-reported, making it difficult to verify performance.

Why it matters

Weak data undermines credibility of the SLMR.

What good looks like

A focus on 1-3 measurable KPIs with meaningful margin adjustments.

Costs **A margin shift should not cost you credibility.**

Cost ambiguity around assurance and advisory support delays negotiations.

Why it matters

In time-pressured deals, SLMRs are usually the first terms to be dropped.

What good looks like

Early clarity on expected costs and how they will be handled.

Collaboration **It takes a village (or at least a shared spreadsheet).**

Club deals or syndicated structures suffer from conflicting priorities and fragmented frameworks.

Why it matters

Misalignment increases friction and can stall or derail the SLMR altogether.

What good looks like

Early alignment on basic principles and focus on KPIs all parties can support.



Case study

How one investor scaled and strengthened SLMRs

Since 2021, dss⁺ has been supporting Arcmont Asset Management, a private credit asset manager with €41bn of capital raised to date, in building and continuously refining its SLMR programme. What began as a bespoke offering with KPIs selected directly from pre-investment ESG assessments, has matured into a structured, firm-wide framework.

Ambition:

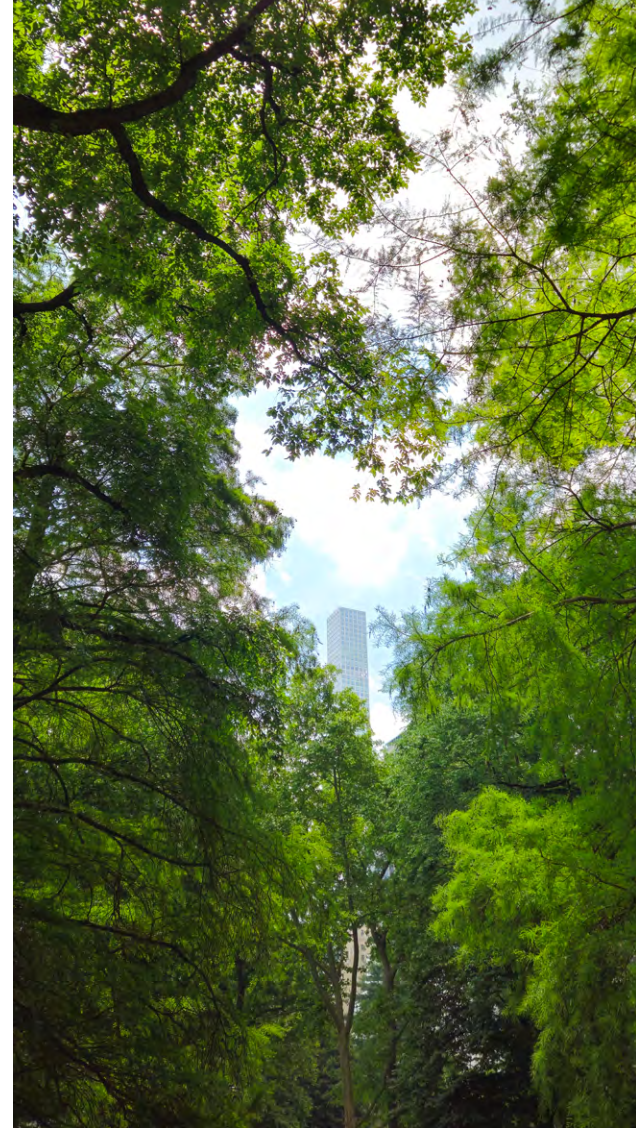
The firm has positioned SLMRs as a default feature for primary transactions where sustainability KPIs are material to the borrower, rather than an opportunistic tool.

Ownership, Accountability and Capability

- The Responsible Investing team leads all SLMR engagements, supported by the deal teams and, where required, dss⁺. The ESG Committee is responsible for reviewing and approving each SLMR prior to documentation.
- Throughout the partnership, dss⁺ has trained the Responsible Investing team, Investment team and ESG Committee on SLMR best practices, ensuring the firm has the required knowledge and skills.
- dss⁺ developed an SLLP scorecard to help the firm assess SLMR proposals consistently across transactions.

KPI Evolution

- Since 2022, the firm has prioritised GHG emissions reductions aligned with the SBTi framework, where material to a borrower. This approach ensures KPIs are quantifiable, benchmarkable, and grounded in climate science. Annual GHG emissions performance data require external verification.
- For other KPIs, the firm leverages the portfolio company ESG assessment that dss⁺ independently reviews, to identify metrics that are both material and quantifiable.



Co-Designed Framework

More recently, dss⁺ supported the development of a presentation for borrowers and sponsors, outlining the benefits of SLMRs, key requirements, and a "menu" of acceptable KPIs. The objective is to achieve early alignment on basic principles and requirements across portfolio companies, sponsors, and co-lenders. The framework incorporates learnings from all SLMRs implemented to date and seeks to address identified areas of friction.

In line with market trends, fewer SLMRs are being signed, but with materially higher quality and integrity. This is what a maturing SLMR strategy looks like: intentional, adaptive, and built to deliver both trust and material sustainability outcomes.

From friction to fluency

A practical roadmap for implementing SLMRs

Whether introducing SLMRs for the first time or refining an existing approach, credible sustainability-linked pricing does not happen by accident. It is built through structure, consistency, and alignment across teams.

Below is a short roadmap based on what we have seen work in practice with private credit managers across markets.

1

Define ambition

- Decide how your firm intends to use SLMRs: as a selective tool, or as a default approach for certain deals or industries
- Set expectations internally and externally. LPs want to see integration, not just intent



Firms that align SLMR ambition with their current investment thesis and strategic objectives tend to achieve stronger internal buy-in and more consistent implementation.

2

(Co-)design a credible SLMR framework

- Standardise, then scale
- Create a framework that defines when to include SLMRs and sets minimum expectations for KPIs, targets, reporting, and verification
- Clarify roles across ESG, investment, and portfolio teams, and agree on cost allocation and stakeholder engagement



Using peer benchmarking, sector-specific templates, and lessons drawn from live transactions helps create scalable frameworks that balance ambition with practicality.

3

Enable deal teams to engage with confidence

- Turn the framework into something deal teams can actually use in live negotiations
- Provide KPI menus, decision trees, templates, and quick access to ESG expertise so sustainability-linked terms feel like part of the credit toolkit, not an add-on



Firms gain most traction when tools and frameworks are built into existing deal processes rather than layered on top. This pragmatic approach enables investment teams to move quickly and credibly when structuring transactions.

4

Pilot in the right place and extract learnings

- Apply the framework in one or two live transactions with receptive borrowers
- Capture where friction arises, with sponsors, co-lenders, or internally, and refine accordingly
- These early applications build internal conviction and provide tangible examples to refine the framework and support wider adoption



Testing the framework with receptive sponsors provides early evidence of value and identifies any friction points that can be resolved before wider rollout.

5

Institutionalise, measure and evolve

- Embed SLMRs into standard processes.
- Make stakeholder alignment part of every transaction, not a separate step
- Track and communicate outcomes – were targets achieved? Was data reported on time? What did sponsors and LPs think?
- Refine based on feedback, and report progress back to LPs



Regular reviews of SLMR outcomes, including whether targets were achieved and data reported on time, create a feedback loop that informs future transactions and strengthens firm-wide governance.



CASE STUDY:

From framework to full rollout

As outlined in the previous section, successful SLMR implementation requires structure, consistency, and cross-team alignment. With support from dss⁺, a leading private markets investor put this into practice, moving from ambition setting to pilot transactions, and ultimately embedding SLMRs into standard post-investment processes.

Key outcomes

- Now engages more investments with sustainability-linked margin ratchets (SLMRs)
- Stronger capabilities to set and negotiate meaningful KPIs and targets
- More consistent borrower engagement on ESG performance
- Enhanced ability to monitor sustainability outcomes and report to LPs
- Greater confidence and internal alignment around integrating ESG into financing terms

[Read the full case study →](#)



From experimentation to embedded practice

SLMRs are no longer an experiment. They are becoming a structural feature of private credit.

The next challenge for lenders and sponsors alike is to move from individual deals to firm-wide practice, ensuring consistency, credibility, and measurable outcomes.



dss⁺

At dss⁺, we support all actors involved in shaping credible SLMRs across the investment chain. We work with private credit firms to translate high-level frameworks into deal-ready structures, helping investment and ESG teams co-develop KPIs, review terms, and build repeatable processes that stand up to scrutiny.

We advise private equity sponsors in a similar capacity, helping them recognise SLMRs as an opportunity to reduce portfolio companies' cost of capital while signalling thoughtful sustainability integration to lenders and LPs.

We also collaborate with corporates and management teams to design material, measurable KPIs and targets that can be confidently proposed to lenders, linking sustainability ambition with credible financing terms.

With over 1,500 professionals supporting companies globally, we bring the operational depth needed to turn commitments into results.

Because ultimately, credible SLMRs don't just reward progress – they might enable it.

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