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The ABCs of ESG

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ESG (Environmental, Social and Governance) is everywhere. From landmark climate regulations approved in Europe in June to new ESG disclosure rules in China, from sustainable investments growing by double-digit multiples to research that ESG methodologies significantly enhance portfolio company performance − hardly a day goes by where there isn't a new report that ESG is soaring. This article continues our series of posts related to ESG in Fund Finance by taking a deeper dive into KPIs (key performance indicators), SPTs (sustainability performance targets) and UoPs (uses of proceeds), the foundational drivers of finance-related ESG. We analyze these according to the SLLP (Sustainability Linked Loan Principles) and GLP (Green Loan Principles) promulgated by the LSTA, LMA and APLMA so that you can structure them effectively in your deals. It's a veritable alphabet soup of ESG.

ESG's Basic Mechanism in Loan Transactions – The Pricing Toggle

Before delineating the details of KPIs, SPTs and UoPs, it will be helpful to briefly discuss the basic structure of ESG in credit facilities in our market. Our colleagues Wes Misson and Katie McShane excellently explained the essentials in their prior *Fund Finance Friday* articles: ***ESG Loans – The Next Big Wave in Fund Finance*** and ***Top 10 Items to Consider When Structuring Your ESG Facility***. The primary feature is a pricing toggle. The borrower and lender first settle on what ESG-related metrics will be measured by the fund under the loan documents. This can take one of two forms: as a "performance-based facility" tied to KPIs and SPTs, or as a "use of proceeds facility" linked to UoPs. The margin is then adjusted from standard market pricing. If the credit facility is performance-based, the margin will depend on the fund's achievement of certain ESG metrics. If based on UoPs, loans used for ESG receive preferential pricing while loans used for general purposes won't.

The margin can be adjusted downward, upward or both. The purpose is for the fund to put pressure on itself to hit its ESG targets. If it doesn't deliver on the performance or use of loans for sustainability or green reasons, the fund might receive an increase in the amount of interest it pays. But if the fund is successful, it may receive the benefit of a downward shift in interest.

The margin adjustment can be tested monthly or quarterly for KPI loans, or with each borrowing for UoP lines of credit. For the former, the borrower consolidates its ESG performance information in a compliance certificate that it delivers periodically to the administrative agent or the sustainability coordinator. If the facility is priced based on UoPs, the borrower specifies in each borrowing request how it will use each loan. In either case, the agent or ESG coordinator verifies the information from a factual perspective and then adjusts the margin.

Determination of ESG Criteria – KPIs/SPTs or UoPs

In entering an ESG loan, the fund and the lender should each consider how it thinks about ESG generally based on its particular focus and overall strategy. The fund will assess what it wants to change or improve in its portfolio investments from an ESG perspective and how it will measure that data to enhance its value proposition. The fund should discuss this framework with its investors and can use it as a starting point for conversations with the lender. Lenders will look to ensure that the KPIs, SPTs and UoPs are robust and not merely a means for the fund to receive a margin deduction.

ESG criteria should be ambitious and meaningful. As such, they should be set to target real change, rather than just being “business as usual” but with an ESG label. And they should take aim at reflecting the fund’s and the lender’s core environmental, social and governance values. If the fund and lender desire to hit specified ESG targets, structuring the credit facility as performance-based would be the natural fit. If the borrower and lender seek for the loans to be used broadly for ESG purposes but without a need to monitor individual goal achievement, then a use of proceeds line could be used.

Structuring of KPIs, SPTs and UoPs

The SLLP and GLP put forth by the LSTA, LMA and APLMA are each intended to assist market participants in crafting their ESG loans. The SLLP consists of five central components: selecting KPIs, calibrating SPTs, linking loan economics to ESG achievement, reporting of data and verification of results. The GLP comprises four core characteristics: use of loan proceeds, evaluating and selecting projects, managing proceeds and reporting loan allocation.

When implementing KPIs, SPTs and UoPs in a credit agreement, it is important that they work for the particular fund based on its market, strategy and operations. For performance-based loans, generally three to five KPIs might be selected. The key is to ensure that the borrower strives for comprehensive objectives without making measurement unduly burdensome over the life of the facility. KPIs can be set at the fund level or at the portfolio company level. Each is then matched to SPTs that, if achieved, would represent a material advancement of the KPI. SPTs should permit quantifiable benchmarking over a predetermined timeline in line with the fund’s investment trajectory and the tenor of the loan facility.

For use of proceeds transactions, UoPs are tied to eligible investments that often have an environmental sustainability design, but may also have social or governance missions. Loan proceeds are tracked to ensure they’re allocated for such investments or related expenditures. The loan parties may formulate how best to assess such flow of funds to confirm the borrower’s compliance with the UoPs. The lender and borrower might also institute eligibility standards to identify if any previously sanctioned investments no longer qualify as ESG. Were that to occur, the related loans would then lose preferred pricing.

Sample KPIs, SPTs and UoPs

In conformity with the SLLP and GLP and based on the foregoing discussion, the following is a detailed but non-exhaustive list of KPIs, SPTs and UoPs that you could utilize in your ESG facilities. The column for KPIs applies equally to UoPs: the borrower would either select KPIs that it seeks to improve, or it would choose UoPs to invest in ESG solutions. While the listed SPTs are meant to tie directly to their respective KPI, the SPT column could also provide fodder to conceive of more narrowly tailored UoPs.

This list is meant to provide a starting point for consideration and idea generation. The metrics you choose in your deals should be specific to the ESG philosophy and strategy of the individual borrower and lender.

KPI/UoP	SPTs
Environmental	
Biodiversity	Protection of endangered species, conservation of terrestrial flora and fauna, increase in regional aquatic diversification
Climate Change	Reforestation, reduction of fossil fuel use, lowering of carbon pollution
Energy Efficiency	Proliferation of energy-efficient buildings, enhanced energy efficiency of equipment, increased energy efficiency ratings among portfolio companies
ESG Assessment	Attainment of ESG certification, increase in quantity and quality of ESG ratings, enhanced ESG reputation
Greenhouse Gas Reduction	Diminished portfolio company greenhouse gas emissions, increased carbon capture, lower chlorofluorocarbon yields in manufacturing
Renewable Energy	Double renewable energy generation, expanded use of solar and wind power, enhanced efficiency-to-cost ratio of alternative fuel sources
Sustainable Agriculture	Improved sustainable agricultural production, enhanced integrated pest management, enrichment of soil fertility
Regenerative Sourcing	Increased soil-based carbon sequestration, improved crop resiliency, expanded supply-chain tracing of regenerative raw materials

Waste Management	Tightened tracking of waste disposal, recovery and reuse of liquid and solid waste products, heightened waste prevention
Water Scarcity	Escalated water savings, growth of aqua-transport infrastructure, amelioration of water contamination

Social

Affordable Housing	Raising affordable housing unit construction, reclamation and preservation of residential developments, neighborhood revitalization
Data Protection	Bolstering data encryption, implement multifactor authentication, expand IT infrastructure and training
Diversity and Inclusion	Instituting of diversity accountability measures for management, growth of diverse employee numbers and retention, deployment of alternative employee complaint systems
Human Rights	Cultivation of local businesses and workforces, advancement of the rule of law and social justice, improved treatment and reduced discrimination of indigenous peoples
Workplace Safety and Health	Improved workplace physical and mental health, implementation of safety management plans, regular training and testing of employees on health and safety protocols

Governance

Board Diversity	Increased board diversity at fund and portfolio levels, enhanced diversity selection rubrics, development of diversity succession planning
Business Ethics	Establishment of enforceable code of conduct, expanded audit and compliance committees, commencement of business ethics education and monitoring
Corporate Transparency	Upgrade internal and external communications channels, promotion of clear pricing strategy, publishing corporate ESG data and statistics
Cost	Development of waste reduction plan, elimination of additional employee

Avoidance	headcount through process improvements, installation of energy-efficient equipment
Enhanced Consumer Engagement	Optimization of consumer touchpoint feedback, strengthened customer retention, shortened purchase cycles
Policy Influence	Deepening of relationships with policymakers, intensified influence over local policy adoption, development of public-private partnerships
Supply Chain Integration	Centralization of material and data silos, deployment of Internet of Things technologies, proliferation of advanced supply chain analytics

Conclusion

The Fund Finance community has an opportunity to make real, meaningful change using ESG. Establishing KPIs, SPTs and UoPs is the foundational first step in structuring our credit facilities to do so.