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ESG in Fund Finance

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In the first of our series “ESG in Fund Finance” articles, we summarise and examine the recent publication “A Guide to the Application of Sustainability-linked Loan Principles in Fund Finance”

Background

The consideration of sustainability and environmental, social and governance ("ESG") issues continue to be a focus for investment funds and financial institutions globally. Sustainability-related regulation, investor demand, and an increased awareness of ESG-related risks and opportunities have accelerated the demand for and consideration of ESG issues in fund finance transactions.

Industry standards (such as the **Green Loan Principles** ("GLP") and **Sustainability-linked Loan Principles** ("SLLPs")) have also continued to evolve and adapt to market practice, regulation and the increased focus on transparency and greenwashing. As the sustainable finance and investment sector analyses these loan products, the LSTA and Loan Market Association ("LMA") have published additional guidance and tools including the **LSTA’s Drafting Guidance for Sustainability Linked-Loans** and the **LMA’s Draft SLL Provisions**. This drafting guidance provides the market with an invaluable starting point for sustainability-linked loan terms allowing parties to focus on credible impact through selection of robust key performance indicators ("KPIs") and sustainability performance targets ("SPTs").

New Guide to structuring SLLs in Fund Finance

In March 2024, the APLMA, LMA, LSTA, and the Fund Finance Association released a first sector specific guide for fund finance - **A Guide to the Application of Sustainability-linked Loan Principles in Fund Finance** (the "Guide"). The Guide provides market participants with practical guidance on the application of the SLLPs in fund finance transactions and identifies and considers the specific challenges when structuring fund finance transactions as sustainability - linked loans ("SLLs").

Sustainability-linked Loans or Green and Social Loans?

SLLs, unlike green or social loans, can be used for general purposes (including the payment of fees) provided that the core components of the SLLP are adhered to. The focus of SLLs is on improving the sustainability performance of the borrower through the selection of KPIs and SPTs which comply with the criteria set out in the SLLPs. Whilst the Guide focusses primarily on SLLs, market participants should also consider whether a green or social loan (use-of proceeds loans) or a combination of use-of proceeds loans and SLLs may be a useful alternative for certain fund finance transactions. This may be the case, for example, where loan proceeds can be used to finance green or social investments, eligible green or social projects and/or for impact funds. Certain sectors (such as infrastructure, renewable energy etc) and ancillary operations related to such sectors may also align more easily to a use-of-proceeds structure particularly where taxonomy alignment and/or disclosures under Article 8 and 9 SFDR can also be taken into account.

What are the challenges of putting in place SLLs in the context of a fund finance deal?

The Guide usefully sets out the key challenges faced by market participants when considering SLLs in a fund finance transaction with a number of these going to effective selection of KPIs and calibration of SPTs. These considerations will differ depending on whether the transaction is structured as a capital call, NAV/ABL, hybrid or GP financing product.

The challenges when incorporating SLLs in fund finance can be grouped into several categories, predominately around the specifics of those facilities, nature of participants and the availability of data.

The availability of quality and relevant data remains a challenge across the sustainable finance and investment sector and fund finance is no exception. These can be particularly difficult in a fund finance transaction because borrowers (especially in the context of the capital call facilities) will typically be newly established funds with little or no historical data, no proven ESG strategy or polices and insufficient operational information at fund level. In addition, in contrast to the corporate loan context, where borrowers are generally able to maintain a fair degree of control over their business affairs and progress towards the achievement of set metrics, in fund finance there is an inherent degree of uncertainty and a lack of control over the fund's pipeline of investments or opportunities. This makes the selection of KPIs and SPTs according to the criteria set out in the SLLP potentially challenging. Tensions may also arise where different sustainability strategies and ESG factors are considered at different levels.

The Guide refers to various approaches being used in the market (including KPIs linked to (i) a percentage of investments, (ii) the operations of portfolio companies holding the investments, metrics set for the fund or a sub-set of fund activities and the gradual phasing of KPIs) and an indicative set of KPIs used in fund finance transactions is set out in the Appendix to the Guide. The Guide also suggests reference to historical performance of previous investment funds by the same parties where relevant and comparable. It will be interesting to see whether the proposed regulation of and industry codes of conduct relating to ESG-rating providers may also result in an increased use of ESG ratings as a KPI (**see LMA Horizon's commentary**).

Some fund financings have a relatively short life, with tenors of 1-3 years in many cases, subject (usually) to extensions. It is also common that the margin adjustments in general SLLs usually start only after the first year of the facility given a need to establish various data points for measurement and time for a verification of the relevant metrics. In the fund finance context, such misalignment is further exacerbated by the availability of historical data or a lack thereof, as many borrowers are newly formed vehicles, in particular with respect to capital call facilities. In some cases, "sustainability amendment event" concept from the SLL drafting guidance has been used to address some of these concerns.

The cost and process of verification has also been raised as barrier to structuring SLLs. Diversity and quantity of investments not only potentially increases the cost of verification (particularly if undertaken on an investment by investment basis) but can also make the process of annual reporting more costly and time-consuming. A combination of these factors can make the SLL product appear to be less economically viable and efficient particularly if the requirements for a SLL (including reporting and verification for example) go beyond those required by investors. The use of sustainability coordinators and parties agreeing the scope of and approach to verification early in the process can address some of these concerns as can the more efficient use of information prepared for other purposes (such as disclosure and reporting (see regulatory commentary in recent LMA Horizons).

Conclusion

ESG integration and the use of sustainable loan products in fund finance transactions continues to evolve rapidly. The size and strength of the fund finance sector emphasise the potential role that the sector has in allocating sustainable capital by lenders, achieving impact through the selection of KPIs and delivering on sustainability-related KPIs of banks, funds, sponsors and investors. Given the multiple layers of impact, the fund finance sector is also well placed to deliver "transition impact" and ESG alignment can enhance liquidity for GPs.

The Guide is an important first step to considering the challenges faced by the fund finance sector globally and setting out potential solutions and key considerations. Over the coming weeks, our ESG Practice and Fund Finance Practice will bring you further insights including a conversation with the trade associations, the lender's perspective and GP Solutions.

For further information on our ESG in Fund Finance Toolkit please contact **Radhika Radia**.

Resources

Unlocking Sustainability-Linked Loans
Click **here** to access a podcast hosted by Sukhvir Basran (Cadwalader) in conversation with Tess Virmani ("LSTA") and Gemma Lawrence-Pardew ("LMA"). The podcast addresses some of the most frequently asked questions raised by market participants on sustainability-linked loans.

Integrating ESG into Fund Finance
Click **here** to access an article by Gemma Lawrence-Pardew summarising the key drivers, challenges and opportunities behind the uptake of SLLs in fund finance transactions.

Horizons
Click **here** to access Horizons, the Loan Market Association's ESG Regulatory Review. As Sustainability Counsel to the LMA, Sukhvir Basran drafted the regulatory chapter, bringing together a round-up of key EU Regulation, ESG Standards, Guidance and Toolkits, and Consultations.

A Guide to the Application of the Sustainability Linked Loan Principles in Fund Finance
Click **here** to access a Guide to the Application of the Sustainability Linked Loan Principles in Fund Finance, which acknowledges various challenges and potential solutions. The guide was published in March 2024 by a joint working group of the Loan Syndications and Trading Association, Loan Market Association ("LMA"), Asia Pacific Loan Market Association and Fund Finance Association.