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Fund Finance Friday

ESG and Green Loans: Some Perspectives

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Introduction: Why are funds and lenders considering and using Environmental, Social, and Corporate Governance (ESG) and Green Loan principles in financing?

Investors are increasingly demanding greater transparency about how their money is invested, and ESG is seen as a value-generating component and a new growth driver for asset managers. Although investors are not usually directly involved in the General Partner ("GP") investment decisions (for legal and operational reasons), they have considerable influence on the overall investment policy of the fund and the context in which the decisions are taken through the setup of the fund. During the marketing phase, investors (also called Limited Partners) in funds (also referred to as Limited Partnerships) can and increasingly do require, through the fund's documentation (Limited Partnership Agreement and/or individual investor's side letter), a commitment from the GP to adopt specific ESG criteria in its investment policy. As a consequence, responsible investment* and compliance with set ESG parameters and measures are increasingly seen as some of the key indicators of the operational capability and excellence of a fund manager. Where the fund is looking for financing, these ESG measures will also and inevitably form part of the financing criteria.

ESG Financing and Green Financing

A. Differences

It is important to stress that ESG and Green Financing are two different types of financing, although both fall under the general umbrella of sustainable financing. Determining which is which depends substantively on what the proceeds of each type of financing are used for. Green Financing includes any type of finance instrument where the proceeds are exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green assets with environmental benefits aligned with the eligibility criteria. The related criteria are basically set forth in a specific Green Financing framework ("GFF") and/or in the facility agreement. The loan is often structured at the asset level, though Green Loans can also be structured at the fund level if the main strategy of the fund is green. In contrast, ESG (also referred to in this article as "Sustainability Linked Loans" or "SLLs") is a financing where the SLL is not dependent on the proceeds being used specifically and exclusively for eligible green assets. The main specificity of an SLL is the pricing adjustment which it offers if the borrower meets pre-agreed sustainable or ESG key performance indicators ("KPI") or targets.

B. Structure

Both Green and ESG Loans can be structured throughout the fund's lifecycle and at different levels: holding company, fund, co-investment funds and/or asset level. Financing can start with the subscription/capital call phase and move on through to the acquisition/NAV phase, with appropriate shifts in the structure of the underlying loans and the way in which the relevant Green or ESG/SLL principles are applied to reflect the stage in the lifecycle. The category of loan will to some extent determine where in the structure that loan is more likely to fall.

Green Loans are generally more suited to being structured at the fund level and, in particular, at the level of a specific fund with a dedicated green investment strategy, *e.g.,* low carbon real estate development fund, infra or renewable fund. Similarly, ESG/SLL structure is possible at the fund level for specific funds where KPIs can be set. Financing at the fund level can be through a Green or ESG/SSL subscription facility, NAV facility or hybrid and asset-backed facility.

When it comes to the holding company level, it is easier to consider ESG/SLLs, as this is where information is consolidated. The most common financing structures at the holding company level are mainly unsecured term loan or revolving facilities.

At the investment company level, either Green Loan or ESG/SLLs can be considered, although Green Loans fit perfectly in individual assets or in the investment vehicle holding a pool of eligible green assets. ESG/SLL Loans may be suited to portfolio companies that could include ESG KPI referencing individual assets – for example, an operating company for renewable infrastructure projects. Typical financing structures at this investment company level are unsecured NAV or asset-backed facilities.

So, Green and/or ESG/SLL concepts can be included in all stages of the debt lifecycle of the fund.

C. Focus on Green and ESG/ SLL Subscription Facilities: Features

Green subscription facility: a fund manager with a green investment strategy (*e.g.*, energy transition, global warming reduction, low carbon strategy) can benefit from a Green Loan to bridge the fund's commitment towards underlying green, eligible investments. This Green Loan will be backed by investor commitments, as is the case for a standard subscription facility. A Green Financing Framework in accordance with the Green Loan Principles ("GLP") can be included in the financing documents. This document will include all criteria required to be met for eligible green underlying assets with the potential expected environmental benefit and climate change mitigations. All proceeds of the Green subscription loan will need to be allocated to eligible green investments as soon as possible after they have been utilized under the facility and, in any event, before the maturity of the facility. The GLP require borrowers to provide regular reports on the allocation of proceeds and the positive environmental impact of their projects.

ESG/SLL subscription facility: In contrast to a Green Loan subscription facility, this structure doesn't involve any specific requirement for allocation of the financing proceeds to any particular purpose. In the current market, the key feature of such loans is a pricing incentive offered if the fund meets pre-defined KPIs such as renewable, low carbon targets or gender diversity indicators. KPIs are always based on the ESG policy of the fund/GP and the defined investment strategy. They need to be carefully considered and agreed between the lender and the fund/GP on this basis so that a set of objective, well-defined and measurable KPIs can be included in the loan documents.

While there is currently no single "market" position for any pricing incentive for ESG/SLLs which we see in the market (and indeed sometimes there is no specific pricing incentive at all), it is a general feature of the financing structure as stated above that it rewards borrowers when they achieve their sustainability targets by decreasing the pricing by a pre-agreed pricing level, while a failure to meet those targets will lead to an increase in pricing. Sometimes these decreases and increases may be subject to ratchets, and it is important to note that the pricing adjustments are relatively small. There is a move in the market in some transactions to include draw stops or default events relating to Green/ESG loans, but it is also important to note that these are not based around compliance or non-compliance with the relevant KPIs themselves but more around any misrepresentation (particularly where there is a degree of fault on the part of the borrower for such misrepresentation) in the reporting related to KPI compliance.

D. Specific Criteria for KPIs

Although as stated there are no absolute "market" standards for the specific KPIs that would be part of an ESG/SLL loan, there are some general criteria worth listing. KPI around investment portfolios will typically look at the integration of the following into investment portfolio selection:

- Environmental, social and governance;
- Percentage of women on boards;
- Percentage of disabled people;
- A healthy living environment;
- A resilient building; and
- The Paris Climate Goal (1.5/2°C alignment), the United Nations Sustainable Development Goals for low-carbon transition assessment

E. Greenwashing

“Greenwashing” is a description of any actions taken by a company or fund that leads people to believe that the company or fund is doing more to protect the environment or follow ESG principles than it really is. Green financing can be impacted by Greenwashing. It is important, therefore, that funds and lenders do not simply pay lip service to ESG principles, and that ESG compliance and KPIs are properly set and measured. To do this, both funds and lenders should seek to agree on suitable “stretch” targets, which are measurable, verifiable and adequate as well as proper and regular reporting criteria to enable compliance with KPIs to be monitored. In terms of assessing compliance, lenders should also look to appoint a specialist “monitor” or opinion party to ensure that reporting and compliance can be properly assessed. Unless all of this is put in place, there is a danger that funds (and lenders) could simply talk about fulfilling ESG criteria without any substantive intention to comply.

The involvement of a monitor or secondary opinion party is useful in such structures not only in validating and monitoring the ESG/Green structure based on the investment strategy of the fund but also in structuring the relevant KPIs. There are now a number of market participants who offer this specific service.

From the fund side, measurable and achievable KPI and covenants can be set based on a comprehensive decision-making investment process, including a specific process allowing for consideration of ESG factors and responsible investment and engagement practices as part of any investment decision.

F. Issues

There is currently no “market standard” for terms for SLL or Green Loans and, to some extent, each transaction will incorporate its own criteria and provisions. It is worth noting that the LMA/LSTA and APLA have produced some high-level “Sustainability Linked Loan Principles,” which summarise the current state of the loan market in adopting or adapting to SLL principles and the various considerations underlying these which are helpful at least in summarising the type of issues which lenders and funds need to consider. To the extent that there might be said to be a “market” position developing, there is currently general consensus that achieving (or failing to achieve) agreed KPIs may lead to a pricing adjustment downwards or upwards in margin (usually fairly minor relative to overall pricing). It is rarer to see any draw stops or defaults linked directly to KPIs, although there are some loans in the market where draw stops or events of default are applied to misrepresentation (often as stated above, where there is a degree of borrower “fault” in such misrepresentation) in KPI reporting.

Similarly, while there are a number of recommendations and principles which apply to SLLs, there is no specific common regulatory or risk management process for Green or ESG/SLL financing shared by lenders. Each lender has its own policy.

In addition, there is no “market” policy green framework to identify measurable KPI and targets to achieve SLL/ESG or Green standards.

G. Solutions and the Future for Green and SLL/ESG Loans

We can expect ESG/SLL loans and, for the right investment strategy, Green Loans also increasingly to become part of the common landscape in Funds Finance as the pressures and incentives to fit loans within these categories continue to build.

We expect that the market will coalesce around more common “market” principles in terms of lenders’ criteria, as well as measurement of and compliance with KPIs.

We would anticipate that, at some point, although this may be some way off, lenders may be subject to more explicit capital requirements which favour (and give some more significant pricing differential than is currently the case to) Green and/or ESG/SLL loans, either through internal capital allocation or incentives and/or through the creation and imposition of external regulations designed to encourage these activities by impacting capital generally.

For the relatively near term, we would anticipate the continuation of minor pricing adjustments as per the above to remain the main feature of ESG/SLL lending, possibly with the addition of default/draw stop events around the reporting relating to KPIs being included. We do not see, in the near term, any likelihood of defaults or draw stops being expanded to cover non-compliance with KPIs themselves.

* PRI responsible investment is defined as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.

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