

CADWALDER

## ESG in Fund Finance – A Banker’s Perspective

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By **George Pelling**  
Partner | Fund Finance

We were very pleased to have the opportunity to speak with Lloyds Bank’s Greg Sidlow (Relationship Director, Funds Finance), Varun Sarda (Managing Director, Sustainability & ESG Finance) and Rebecca Tozer (Associate Director, Sustainability & ESG Finance) to discuss the increasingly prevalent nature of ESG concepts seen in the Fund Finance market.



Varun Sarda



Greg Sidlow



Rebecca Tozer

**Fund Finance Friday:** Greg, Varun, Rebecca – thank you very much for taking the time to contribute to *FFF* and for providing your thoughts on the ever-evolving ESG constructs in fund financing. It was fantastic to work with you both on your recent deal with [Cinven](#), which incorporated a variety of bespoke ESG KPIs across the fund manager’s platform.

Greg: Thanks for having us.

**FFF:** Greg, if we could start with you. Could you give us some insight from the banker’s perspective on the role of ESG within the fund finance market?

Greg: ESG has long been on the agenda for LPs and GPs, with many sponsors being signatories to the UN Principles for Responsible Investment. ESG forms a key part of LPs’ diligence process, and we only expect this to continue to grow in prominence going forward.

GPs have also built out dedicated ESG teams to help integrate ESG due diligence and management of risk and opportunity throughout the investment cycle. ESG monitoring and reporting have been built out accordingly, with the creation of the ESG Data Convergence Project in September 2021 being a notable industry development.

In line with the wider loan market, the fund finance industry has witnessed significant growth in ESG/sustainability-linked loan (SLL) financings over recent years. The ESG activities undertaken by many sponsors often serve as a helpful foundation for creating the key performance indicators (KPIs) and sustainability performance targets (SPTs), which typically analyse the performance of the underlying investments rather than the sponsor themselves.

We have also seen this translate into GPs incorporating ESG aspects into the leverage financing they arrange for their underlying portfolio companies. While we have not seen the inclusion of such ESG features threaten liquidity for fund financings, it has served to increase lenders’ appetites in certain cases given the focus on ESG lending from many institutions.

Structuring an SLL requires specific diligence and close dialogue between ESG teams within sponsors and banks arranging the financing to ensure the facility is set in line with the LMA Sustainability Linked Loan principles.

**FFF:** We have worked on a number of ESG fund financing deals and found that you have one of the largest dedicated teams working on ESG and sustainable finance, including SLLs. Varun, Rebecca, could you tell us a bit more about that?

Varun and Rebecca: We strive to create a more sustainable and inclusive future for people and businesses, shaping finance as a force for good. One of the areas where we can make the biggest impact is by ensuring our clients have access to the best ESG knowledge, skills and experience required to help build a more sustainable and inclusive economy. Our team, Sustainability & ESG Finance, has just passed its first anniversary, as a now 20 person-strong team. This team supports our corporate and institutional clients with sustainability and their associated ESG financings. We bring deep technical expertise across ESG consultancy, Net Zero and climate strategy, ESG ratings, sustainable finance law and sustainable finance. Our Sustainability & ESG Finance team operates on a sector-aligned model so that we can bring dedicated industry insights into our discussions and lenders on some of the specific nuances, challenges, and market understanding of the fund finance industry and wider private markets ecosystem.

**FFF: Do you adopt a different approach on addressing ESG principles when dealing with private funds compared to companies?**

Varun and Rebecca: The LMA SLL Principles (and their regional equivalent) are the core principles to abide by when drawing up an SLL. The Principles help protect the integrity and applicability of the SLL product and provide a helpful framework for lenders to follow around areas such as the selection of ESG KPIs, the calibration of SPTs and the role of Sustainability Coordinator. In order to claim compliance with the LMA principles, private funds are required to adhere to all the core requirements of the principles. As Coordinator, we analyse the composition of a fund's portfolio and evaluate the influence the fund manager has on performance against KPIs. There may be a variance in asset class or sector (and thus ESG materiality) for different funds, and some funds span many sectors. Drawing on our team's experience and knowledge, we carefully review each proposition, working in conjunction with the client to encourage a KPI and SPT selection that incorporates the most material ESG risks and opportunities to the fund. A further distinction with private funds is that some funds are blind pools at execution of the facility, so we don't have historic portfolio data to analyse to determine the stretch of the targets. In these cases, we tend to analyse prior funds and portfolio construction of the manager, and set targets related to the timings of acquisitions rather than take a portfolio coverage approach, for example.

**FFF: What are the benefits of ESG loans to a lender?**

Varun and Rebecca: There are a number of reasons why lenders are increasingly attracted to SLLs as a product. Firstly, it could be because there is a growing demand for sustainable financing in their client base. As of December 2021, ESG financing totaled close to \$1.2 trillion, up from nearly \$500bn at the same time the prior year. Of this, a sizeable portion were sustainability-linked and green loans. Secondly, many lenders have signed up to the Net Zero Banking Alliance (NZBA) and the Glasgow Financial Alliance for Net Zero (GFANZ), which involves them committing to reduce their financed emissions in line with Net Zero and accelerate the decarbonisation of the economy. We therefore need to engage our clients on ESG and SLLs and act as an enabler for this, helping to build strong relationships between the lenders and various departments on the client side. Thirdly, banks are increasingly looking to grow their own ESG-aligned portfolio, announcing sustainable finance lending commitments and preparing for regulatory-driven green lending capital requirements that may follow. Finally, ESG increasingly features in lender-client discussions and tends to encourage greater transparency, which is deemed to be a particular benefit in the private funds market.

**FFF: Is it possible to ascribe a monetary value to this?**

Varun and Rebecca: The most common ESG pricing structure we see in SLLs is the two-way ESG margin adjustment ratchet, which as the name suggests toggles the overall margin paid up (*i.e.*, the borrower pays an ESG margin premium) or down (*i.e.*, the borrower receives an ESG margin discount) depending on how the borrower performs against the selected KPIs and associated targets. The ESG margin adjustment is not huge and usually only a small fraction of the overall margin. Given the two-way ratchet, the ESG structure is viewed as neutral to both the borrower and lender at the point of signing the loan agreement (with only future performance against KPIs determining whether an ESG margin premium or discount is applied). Hence, lenders do not view this as a chance to increase monetary value from loans; rather, they view the ESG margin adjustment there to incentivise positive borrower performance against KPIs. Given the public commitments lenders have made (*e.g.*, NZBA), it is critical that lenders support borrowers' transition to a more sustainable future in a fair manner.

**FFF: Similarly, what do you see as the key benefits for private funds and their investors?**

Varun and Rebecca: ESG loans offer funds the opportunity to showcase their ESG ambitions to the market by tying their sustainability strategy into their financing. Setting KPIs and SPTs can help the fund's key stakeholders, such as investors and banks, to understand the fund's non-financial impact but can also improve its workforce appeal, with evidence suggesting that younger potential employees are commonly influenced by ESG when choosing where to

work. Moreover, setting annual targets and encouraging monitoring and reporting of verified KPIs aptly positions funds for upcoming reporting that will be mandatory for many under CSRD and recommended under SFDR. While the pricing benefit isn't huge and isn't usually the main draw for funds, it can represent a significant driver of positive change, especially on larger drawn facilities. Furthermore, investors encourage GPs to embed ESG across all their procedures, including fund finance, and to integrate ESG into all stages of the investment process, taking advantage of the opportunities as well as mitigating the ESG risks, to create long-term value. Investors are increasingly enquiring into funds' ESG performance, understanding that credit risk will soon incorporate ESG evaluation, meaning that it may become harder to access liquidity without a consideration to ESG. On a related but separate point, it should also be noted that, slowly but surely, access to bank capital is evolving, with liquidity starting to concentrate around sectors and borrowers that are focused on sustainability, with KPI-linked SLLs being the primary way of demonstrating sustainability commitments (which, in turn, helps lenders achieve their own sustainability commitments in terms of financing lower emissions and helping borrowers transition to a more sustainable future).

***FFF: What are the challenges you face in negotiating ESG provisions in fund financing transactions, both with negotiating opposite the borrower and also negotiating with other syndicate partners?***

Varun and Rebecca: Most funds understand that the benefits of executing an SLL need to be balanced against the reputational risk of executing a transaction perceived to be unambitious, which could lead to a heightened risk of 'greenwashing' accusations. This, together with the private nature of the market, means that sponsors tend to be more cautious than clients in other sectors, often opting to keep their KPIs private. With the rise of ESG, many funds are interested in discussing ESG Finance and are surprised to hear the level of information required from their portfolio companies, leading to the recommendation of longer lead times for deals so that they are done right, rather than rushed. In addition, varying levels of interest and in-house capacity can affect funds' abilities to influence ESG improvement.

On the lender side, we have seen a fairly significant range in styles and sophistication for tackling ESG Finance. Some lenders have strongly developed teams and governance committees that support their engagement in ESG transactions, whereas others do not. Some deals have been done where less challenging targets were set or less rigorous verification signed off on; these deals coordinated by less-experienced lenders set undesired precedents, compared with best-practice deals that we promote and relish. That being said, we are increasingly seeing lenders push back on some SLL approaches and, in extreme cases, declassifying SLLs internally due to their own ESG governance. In short, lenders are no longer all 'term takers,' and scrutiny around the integrity and robustness of ESG metrics will soon be commonplace.

***FFF: What considerations do you have to ensure the relevant ESG terms and associated KPIs should be measurable, reportable and achievable by the borrower?***

Varun and Rebecca: KPIs are typically tailored to a borrower's overall sustainability strategy. The key to market credibility is ensuring that the KPIs are relevant, meaningful and stretching. Agreed KPIs should ideally align with sector priorities and be mapped to reputable external assessment bodies (e.g., SBTi), as well as aligning with the LMA principles. In order to be measurable and reportable, the fund needs to ensure that its portfolio companies are reporting against the same KPIs, in the same units and measurements – standardisation of measurement and reporting across a fund is crucial. This will also aid independent assurance and verification.

***FFF: Looking at the current macro socioeconomic and geopolitical climate, there have been a number of significant events that have caused some concern in the lending market generally. In particular, we're thinking of the invasion of Ukraine, the development of sanctions policy, high inflation and the threat of a recession. How have these events shaped your view in how you address ESG constructs?***

Varun and Rebecca: These macro events are, of course, relevant from an ESG perspective but – given the breadth of the topic – we are primarily interested in how these events are manifesting themselves into material ESG risks and opportunities for underlying borrowers. For example, human rights, labour mobility and supply chain resilience are becoming key areas of focus in our assessment. Furthermore, there is growing awareness within the banking community that ESG risks are no longer intangible long-term risks; rather, as shown by recent climate and geopolitical issues, these ESG risks can crystallise quickly (including through regulation and rapidly changing stakeholder views), affecting the financial stability of companies and sectors. We are integrating assessment of ESG risks into our credit approval process which looks to scan horizon ESG risks that may impact the credit risk profile of borrowers (via what we call 'ESG credit risk factors').

**FFF: Similarly, how have allegations of greenwashing or general criticism influenced your shaping of ESG constructs and/or dealing with the borrowers' ESG officers?**

Varun and Rebecca: As mentioned before, lenders are increasingly becoming more sophisticated in their approach and challenging the ambitiousness of SPTs, with increased scrutiny and governance on their side to protect against greenwashing allegations. We typically engage in comprehensive discussions with a borrower's ESG officers to dissect the LMA principles, relevant sector materiality maps and industry guidance (that is publicly available), so that they understand what is expected of them when entering into an ESG financing. While we aim to work closely with funds, we won't shy away from declining the sustainability aspects of a transaction if we don't believe in their robustness.

**FFF: Given that ESG is certainly becoming more 'mainstream' (indeed, there is rarely a deal we see which does not involve a conversation around whether ESG concepts can be included and many historic deals we have put in place are being amended to include ESG constructs), are you starting to see an alignment/more standardised ESG terms and KPI metrics?**

Varun and Rebecca: We are, thankfully! Some of the facilities executed in the years before the publication of the LMA SLL principles would not stand the rigour and scrutiny in today's market. As the market evolves, we are seeing strengthening criteria, stretch of targets and rigour of verification, which protects all participants in the financing. While documentation and terms still vary, it is standardising across the market, with funds tending to choose similar KPIs that facilitate benchmarking and peer comparison.

**FFF: Looking forward, do you think that the pressure to deliver investor returns in a challenging economic environment could result in ESG terms and KPIs loosening? Further to this, does the discussion around ESG regulations impact your view on how ESG in fund finance will develop?**

Varun and Rebecca: We don't think ESG terms and KPIs will loosen; if anything, they will strengthen. While many investors are understandably focused on returns, many are increasingly enquiring about ESG and understand that, in order to preserve the value of their investments in the longer-term, ESG improvement is required. ESG regulation will promote increased transparency, monitoring and reporting. Regulatory requirements will activate funds that are currently resisting ESG, driving the slow-movers up the curve, increasing overall ESG performance and verification in fund finance.

**FFF: There's been a lot of talk about the use of ESG ratings for public companies and possibly at fund level. Do you think these could ultimately replace the use of KPIs as a way of measuring ESG performance in the future – particularly in the context of sustainability-linked loans?**

Varun and Rebecca: ESG ratings have been used for some time as KPIs, either alone (covering the whole spectrum of E, S and G) or as part of a KPI suite. Ratings are a great way to quantify and evaluate ESG performance in a single measure, facilitating the setting of targets and benchmarking. This could potentially be a game changer in helping to evaluate portfolio company and fund-level performance; however, it requires significant up-front time and investment. Rating agency methodologies can differ greatly, and some will be better suited to some private funds than others. We have recently launched an ESG Ratings team to support clients in this regard. Beyond linking to any specific SLL borrowings via a KPI, we find that ESG Ratings are increasingly being used by stakeholders in their overall assessment of companies and funds – impacting both the debt and equity story. Suboptimal ESG Ratings can impact access to capital, and at the very least pose challenging questions when fund raising. We are actively working with clients to provide insights on ESG ratings and the fragmented rating agency landscape with a view to optimising ratings.

**FFF: Finally, if you had a (solar or wind powered) magic lamp, what three changes would you like to see to ESG financing generally?**

Varun and Rebecca: Increased ambition, transparency and quality of verification.

**Greg Sidlow** is one of the Relationship Directors in the Sponsors & Structured Finance Group at Lloyds, managing a scale portfolio which is principally comprised of large & mid-cap European primary private equity sponsors.

Greg has led some of the largest capital call and Sustainability-Linked Loan financings in the European market, both in terms of absolute quantum and the scale of syndicates involved. Greg has also successfully originated, structured and

*executed continuation fund financing, GP co-invest and NAV facilities as well as Fund level and Management Company FX solutions.*

*Greg has a deep sector knowledge of private markets, having worked within Fund Finance for over 12 years and been in his current role since 2014.*

**Varun Sarda** leads the ESG Advisory team in Sustainability & ESG Finance at Lloyds and has a particular focus around the Financial Services and Financial Sponsors sectors. He has over 15 years' experience across roles in sustainable financing, ESG ratings, sustainability and climate change consulting, in-house sustainability governance and implementation and the NGO sector.

*Prior to joining Lloyds, Varun led NatWest's ESG Advisory business in Corporate & Institutional Coverage. Before that, Varun led NatWest Group's foray into integrated reporting and engagement with institutional investors on sustainability. He also led the Group's approach and response to various ESG ratings, benchmarks and performance measurement.*

*Varun has also previously worked in environment and social risk management, covering sectors such as Oil & Gas and Power Generation, and he worked at two leading ESG ratings agencies (Innovest Strategic Value Advisors and EIRIS), both of which are now majority owned by MSCI and Moody's, respectively.*

*Varun is a regular public speaker on sustainability in finance and ESG stewardship. He has a Master's from the London School of Economics (LSE) and a Bachelor's degree from Imperial College London.*

**Rebecca Tozer** joined Lloyds in 2018 and has worked across credit and coverage functions of the Commercial Bank in London and in Paris. She has worked in the Sustainability & ESG Finance team since it was set up in June 2021. Rebecca is the ESG Industry Lead for Financial Sponsors, delivering ESG origination and market insights to her client base. She supports the end-to-end experience from initial introductions to ESG, through the development of sustainability strategies, and on to sustainability-linked financings and frameworks.

## Private Debt Investor: The Questions Investors Need to Ask about Fund Finance

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In this article, *Private Debt Investor* surveys fund finance industry leaders to explore LPs' increased comfort with the use of subscription facilities by GPs, LPs' evolving attitudes towards NAV financings, and how a potential economic downturn might impact the fund finance market. Please find the article available [here](#).

## Fund Fanatics Episode with Gen II Fund Services' Jeff Gendel

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Tune in to the recent [episode](#) of Fund Fanatics for a robust discussion with Jeff Gendel of Gen II Fund Services about Fantasy Football, as well as the evolving role of the Private Equity CFO and how companies can keep up with the growth of the industry.



## Fund Finance Hiring

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Fund Finance Hiring

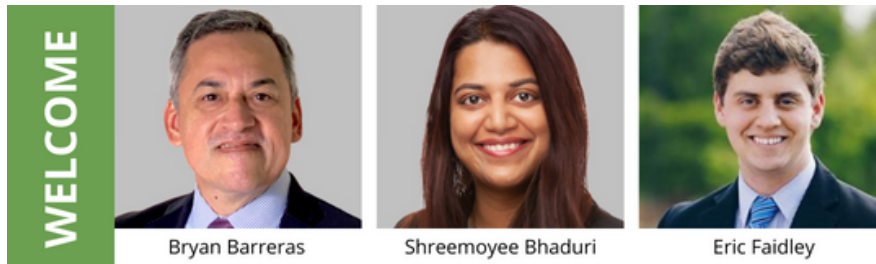
Webster Bank is looking to hire a Vice President for its Fund Banking group.

Responsibilities will include leading deal teams in underwriting and portfolio management for subscription line facilities and other fund-level financings. Required qualifications include 7-10 years' experience in commercial credit underwriting, including at least 2-3 years' experience underwriting fund-level financings.

For further information and to apply, please visit [here](#).

## Cadwalader Welcomes New FF Team Members

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We are very pleased to welcome counsel Bryan Barreras, associate Shreemoyee Bhaduri and law clerk Eric Faidley to our team.

- Bryan Barreras (Counsel, New York): Bryan's practice focuses on fund finance, including fund of hedge funds, secondaries financing, NAV facilities, subscription lines and hybrid transactions. He has spent the past 20 years in the finance industry in various capacities, though primarily as a lawyer in-house at investment banks and in private practice at law firms, and he was most recently a banking and finance partner at a major law firm in the fund finance space. Bryan's practice and experience during this time has focused on financing transactions involving various types of funds (private equity funds, hedge funds, mutual funds and funds of funds). Bryan has also worked as a structurer at a hedge fund and managed operations at a tech start-up.
- Shreemoyee Bhaduri (Associate, New York) received her LL.M. from Vanderbilt University Law School, and her B.A. and LL.B. (Hons) from Nirma University, Institute of Law.
- Eric Faidley (Law Clerk, Charlotte) received his J.D. from Duke University School of Law and his B.A., *summa cum laude*, from Furman University.

## Welcoming Leading Financial Restructuring Partner Mike Rupe

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We are pleased to welcome partner Mike Rupe to our Financial Restructuring Group in New York. He joins as Head of Special Situations and Reorganizations.

Mike advises financial institutions in all aspects of in- and out-of-court workout, restructuring and reorganization matters, with an emphasis on advising ad hoc lender groups. Mike has represented creditor groups in a number of high-profile chapter 11 cases and out-of-court restructurings, including those of CEC Entertainment, APC Automotive Technologies, Fairway Group Holdings, Gymboree Group and Payless Holdings, among others. Among his career highlights, Mike led the team representing a cross-over lender group in the chapter 11 cases of Nine West Holdings, for which he was recognized by *IFLR1000* as a finalist for “Lawyer of the Year: Restructuring and Insolvency.”

Mike formerly practiced at King & Spalding, where he served as Head of Financial Restructuring.

Read the full announcement [here](#).