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Sustainability-Linked Loans Series, Part 5 – Application of Sustainability-Linked Loans Principles to Real Estate Finance Transactions

By **William Lo**
Associate | Real Estate

By **Carl Hey**
Associate | Real Estate

In our August edition of *REF News and Views*, we continued our deep dive into the Sustainability-Linked Loan Principles ("SLLP") core components ("Core Components") and looked at loan characteristics, reporting progress against sustainability performance targets, and verification.

As a reminder, the SLLP set out a framework, enabling all market participants to clearly understand the characteristics of a SLL. The framework is based around the five Core Components, namely:

- selection of key performance indicators ("KPIs");
- calibration of sustainability performance targets ("SPTs");
- loan characteristics;
- reporting progress against SPTs; and
- verification

In this installment in our Sustainability-Linked Loans Series, we will discuss the application of the SLLPs to real estate finance ("REF") transactions and consider some associated issues.

SLLPs in a Real Estate Finance Context

In March 2022, the Loan Market Association ("LMA") published a guide on the application of the SLLP to real estate finance and real estate development finance transactions (the "**REF Guidance**").

In response to the rising demand in the real estate finance and real estate development finance industry to integrate sustainability in their financing solutions, the LMA launched this initiative. Following the LMA's launch of the SLLPs in 2019, SLLPs became increasingly popular in the syndicated loans market. SLL volume began to surpass that of green loans. However, the real estate finance industry has not yet benefited from this rise in SLL popularity. In the REF market, green loans are significantly more prevalent than SLLs.

This REF Guidance sets out what borrowers, finance parties and their advisers should consider when looking to align their transactions to the SLLP. It adds a REF focus to the existing SLLPs and accompanying guidance and includes sections on:

- the roles of the parties involved in a SLL in ensuring the transparency and integrity of the SLL product;
- selection and disclosure of KPIs (with examples tailored and applicable to REF deals – which we will discuss further below);
- calibration of SPTs;

- reporting and verification; and
- documentation considerations.

The LMA has previously published similar guides for the application of the Green Loan Principles to REF transactions. The REF Guidance does not apply to residential mortgages or any other form of retail lending.

Issues with the Use of SLLs in REF

The use of SLLs to date in the REF and real estate development finance context has largely been focused on financing real estate investment trusts ("REITs") and in relation to social housing projects, but the LMA has acknowledged that in general there are certain practical challenges that may arise in applying the SLLPs to the REF and real estate development finance context.

These challenges are set out in the REF Guidance:

- REF lending is typically made available to a borrower that is a special purpose vehicle ("SPV") with no trading history. Such an SPV borrower is unlikely to have a pre-existing sustainability strategy and/or access to historical environmental, social and governance data. To the extent that there is no available data, then this may cause challenges with a SLL in selecting KPIs and calibrating SPTs. As the REF Guidance acknowledges, this may be easier where (i) there is a portfolio of properties being financed, (ii) capex is required to finance retrofit works or (iii) where the property being financed is an operating asset.
- Generally, on REF investment finance transactions, the borrower does not itself occupy the property being financed and in fact may not have direct control over the fit-out or day-to-day operation of the property. The borrower may have some ability to require its tenants to adhere to the SLLPs or green loan principles via provisions in the underlying leases. However, as the borrower cannot in practice control the actual activities of the tenant occupying the property, it may be reluctant to commit to targets that are outside of its day-to-day control.
- There are still divergences in the market as to what is considered "doing enough" in terms of improving sustainability performance in the REF and real estate development finance contexts. This can lead to concerns over greenwashing (*i.e.*, the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact it does not meet basic environmental standards) that can cause reputational damage to both borrowers and lenders.

Notwithstanding the above issues, there have still been various SLL deals in the REF and real estate development finance contexts. The REF Guidance notes that there is still significant potential for further growth of SLLs in the REF and real estate development finance contexts due to a number of factors, such as: (i) the need to decarbonise existing building stock to meet global climate targets, (ii) to improve the sustainability of construction methods and materials, and (iii) to tackle the shortage of affordable housing globally.

REF-focused KPIs

The REF Guidance sets out some common categories of KPIs seen in the REF and real estate development finance contexts, together with an example of the improvements which a KPI in this category might seek to measure. Examples include:

- **Energy efficiency**: Improvements in the energy efficiency rating of building(s) owned or leased by the borrower (often demonstrated using a sustainable building rating, standard or certification). Improvements in energy efficiency can relate to in-use performance and/or the fabric of the building(s).
- **Sustainable sourcing**: Increase in the use of verified sustainable raw materials/supplies in the construction or refurbishment of building(s) or development being financed.
- **Embodied carbon**: Reductions in embodied carbon associated with the development being financed.
- **Clean transportation**: Improvements in the use of low carbon transport and related infrastructure, including electric vehicle charging points and dedicated bicycle spaces.
- **Affordable housing**: Increases in the number of affordable housing units developed by the borrower.

For more examples, please see the **REF Guidance**. We note that the examples contained in the REF Guidance are not exhaustive and are intended to be indicative only.