A Guide to the Application of the Sustainability Linked Loan Principles in Fund Finance

FUND FINANCE association

APLMA Asia Pacific Loan Market Association

LMA Loan Market Association

LSTA ADVANCING THE CORPORATE LOAN MARKET

Introduction

Environmental, social and governance (ESG) issues continue to be a focus for investment funds. Investors are increasingly looking at a fund's strategy and agenda regarding sustainability, social and governance considerations in making investment decisions. Regulatory requirements are expected to further mandate additional disclosure and awareness on the part of sponsors. Likewise, financial institutions and other lenders are increasingly placing a higher degree of scrutiny on the ESG activity of their borrowers as they continue to develop their own ESG parameters or align financings to sustainability goals.

Consequently, interest in sustainability-linked loans (SLLs) in fund finance transactions continues to grow[1]. Given the size and strength of the fund finance market, incorporation of sustainability parameters has the potential to play a significant role in investment fund sponsors' and lenders' ongoing commitment to, and incorporation of, ESG policies and goals.

Following the launch of the Sustainability-Linked Loan Principles[2] (SLLP) in March 2019, many lenders and borrowers in the fund finance industry have looked to the SLLP for guidance on the implementation of SLLs into fund finance transactions. However, even where a fund has a sophisticated strategy that applies ESG considerations into its investment decisions and/or operations, challenges can arise in the application of the SLLP to fund finance facilities, including (a) difficulty of setting key performance indicators (KPIs) due to a fund's limited physical operations, uncertainty of investment pipeline or a lack of consistent metrics across a fund's underlying investments, (b) limited historical ESG data on borrowers, the fund or sponsor, as applicable, and the underlying investments and (c) shorter tenors relative to other types of financings. Despite these challenges, it is important that lenders and borrowers retain consistency with the SLLP in sustainability-linked fund finance transactions.

This Guide seeks to provide practical guidance on the application of the SLLP in fund finance transactions by identifying challenges and considerations that may arise and discussing how the SLLP can be best utilized in the fund finance market in a manner consistent with the overarching goals of the SLLP. While the Guide aims to reflect approaches that have been adopted in the market, such methods may not be suitable for every transaction and lenders and borrowers should discuss each transaction to determine how best to proceed.

Differentiating Green Loans, Social Loans and SLLs

A key differentiator between SLLs and green loans or social loans, is that the proceeds of green loans or social loans must be used exclusively to finance green projects or investments or projects or investments with a specific social impact. SLLs do not mandate use of loan proceeds for green or social projects or investments; rather the proceeds of SLLs can be used for any specific or general corporate purposes. The focus in an SLL is on improvement in the borrower's sustainability performance or attainment of a specific goal (i.e., a KPI) by tying economic or other commercial terms to pre-defined sustainability performance targets (SPTs).

Structuring a fund finance transaction as a green loan or social loan may be possible if the loan proceeds are solely to finance the development or purchase of one or more green or social investments and such investments would otherwise fulfill the criteria of a green or social project or investment. Given that many investment funds will use loan proceeds from a fund finance credit facility for a variety of investments (as well as for working capital purposes) many borrowers may find use of proceeds limitations in green loans and social loans to be too restrictive for their intended purpose. Additionally, if a fund does not control the management or operations of an investment, it may not be involved in directing, developing, managing, or overseeing specific metrics and intended impacts for its investments. This may pose challenges for investment funds as green loans and social loans focus heavily on the criteria upon which the specified project qualifies as a green or as a social loan, including specific goals, stated impacts, thresholds, and quantifiable metrics.

Nevertheless, a green loan or social loan may be desirable for funds investing in sectors (such as infrastructure or renewable energy) that are more likely to be able to achieve a specific environmental or social goal or for funds that are dedicated solely to environmentally or socially impactful investments. While this Guide will focus solely on the implementation of SLLs in fund finance transactions, the loan market trade associations have separately published Green Loan Principles[3] and Social Loan Principles[4] which may be useful in determining whether a loan utilized by an investment fund for purposes of investing in a green project or social project may qualify as green or social, as well as other relevant criteria and considerations. In certain cases, the establishment of tranches or sub-limits aligned with the Green Loan Principles or Social Loan Principles under fund finance facilities may provide capacity to cover investments of this type under a broader, diversified mandate of the fund.

1. Fund finance transactions generally include credit facilities issued to investment funds for purposes of financing investments and other fund expenses. These facilities may be secured by the capital commitments of investors in the fund (subscription line facilities) or investments of the fund (NAV facilities) or a hybrid of both or may be offered to a sponsor to support its investment in managed investment funds
2. https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/
3. https://www.lsta.org/content/green-loan-principles/
4. https://www.lsta.org/content/social-loan-principles/

Challenges in Applying the SLLP to Fund Finance Transactions

Practical challenges have been observed in applying the SLLP in the context of fund finance transactions for myriad reasons, summarized but not limited to the below:

1 The borrower in a fund finance transaction (particularly in a subscription line) will often be recently formed, with limited historical data or without a pre-existing sustainability strategy at the fund or portfolio company level where investments are held. Comparability with other funds affiliated with the borrower may also be imperfect, as strategy may differ from fund to fund. This limited data may make it difficult to assess whether an SPT is realistic and sufficiently ambitious (above and beyond "business as usual") in the context of the borrower's business.

2 It can be difficult to identify relevant KPIs at the fund level because the borrower often will have limited internal operations (e.g., limited or no physical office space and few employees). In such case, any sustainability or ESG focused strategy related to the borrower's operations may be implemented by its investment fund sponsor. To the extent that a sponsor is maintaining a strategy relevant to its internal operation, such strategy may be more appropriately applied to an SLL at the sponsor level, as opposed to multiple SLLs offered to individual funds benefiting from such strategy.

3 As funds are increasingly including ESG considerations in their investment strategy, borrowers in fund finance transactions may look to investments as a means to formulate KPIs (i.e., investment level KPIs), particularly given that the application of such considerations at the investment level may have a material impact on a fund's investment decisions. However, uncertainty and lack of visibility over the fund's pipeline of investments may make it challenging to pre-determine sufficiently relevant, and material KPI's and ambitious SPTs that can be consistently applied across different investments (as an example, quantifiable metrics that may be applied to an investment in renewable energy may be inapplicable to a separate investment in transitional energy infrastructure). Investment level KPIs may also require lenders to review the process by which investments are selected and administered in a manner that is more in-depth than customary diligence performed on the borrower's investment strategy in a fund finance transaction. For investment level KPIs, the length of time holding the investment should also be considered, particularly when determining whether the SPTs should be gradual, becoming more ambitious with each year, or phased in over time.

4 While ESG considerations continue to be a focus for funds, some funds are just beginning to formulate ESG policies and face differing priorities from investors. While many investors are increasingly focused on incorporating ESG considerations in a fund's investment policy, if the proposed SLL would place requirements on the fund that are more restrictive than those required by investors (particularly in respect of third-party verification, as discussed further below) or discourage the fund from making investments that the investors would otherwise support, investors and funds may not view an SLL as an efficient allocation of resources.

5 Diversity and quantity of investments can create concerns with the third- party verification process as it can be cost-prohibitive to receive verification on an investment-by-investment basis and difficult to gather sufficient data from portfolio companies or find appropriate third-party verifiers across differing investments. This is further complicated by the fact that portfolio companies may be controlled by different entities, each utilizing their own standards and metrics. If the costs of performing the verification are substantial, it could be a significant deterrent to borrowers.

6 With respect to investments where the fund does not control the portfolio company, it may be difficult for it to exert the requisite level of control required to ensure sufficient data can be collected, or compliance with a stated SPT can be achieved (and in such a situation an SPT that requires the borrower to take specific action may not be appropriate if it is the underlying portfolio company and not the borrower taking the action). Likewise, where the fund controls all or a substantial majority of its portfolio companies it is necessary that it is not using identical components to satisfy the KPIs across portfolio companies (for example, diversity in leadership in a portfolio company should not be satisfied by appointing the same individual to all portfolio companies).

7 For funds with an investment mandate solely dedicated to advancing stated ESG objectives, it may appear that their significant commitment to ESG could lend itself to implementation of an SLL. However, if a suitable KPI or SPT beyond "business as usual" cannot be determined in accordance with the SLLP, such fund will not be eligible for an SLL and a Green Loan or Social Loan may be more appropriate, as discussed above.

8 Many fund finance facilities have a relatively short tenor of 1-3 years. As SLLs will typically only apply a pricing adjustment following the initial year of a facility (or longer in a fund finance transaction if the initial year is needed to establish historical data), a shorter-term facility may make it difficult to both gather sufficient data and apply it in a manner that will make the effort of putting a sustainability feature in place worthwhile to the borrower.

9 Finally, market convention and applicable regulations as to the application of sustainability principles to investment funds continue to evolve and differ by jurisdiction, both in the context of identifying funds as "ESG" or "impact" focused funds and determination of metrics that should be applied to specific investments that are classified as green or social. Lenders and borrowers should remain cognizant of current requirements when negotiating KPIs and SPTs or making determinations as to the viability of stated objectives and ensure that SPTs go above and beyond what would otherwise be required by regulation.

The challenges identified above are not exhaustive and may not be applicable to every fund. The lender needs to carefully diligence each borrower individually to determine what applicable concerns may apply and whether the borrower could be eligible for an SLL. Notwithstanding the presence of one or more of the above considerations, lenders and borrowers may conclude that a specific consideration need not preclude the incorporation of SLL provisions so long as the proposed transaction is administered in accordance with the SLLP.

Selection of KPIs

As a result of the considerations attendant to a fund finance transaction, lenders and borrowers have adopted differing approaches to the implementation of sustainability-linked provisions into credit facilities. In each case a crucial component remains that selection of KPIs, and incorporation of pricing adjustments, must be tied to ambitious sustainability objectives relevant to the borrower's core business or investment strategy beyond business as usual or mandated legal or regulatory requirements, so as to maintain the integrity of the SLL market.

Borrowers may seek to apply KPIs based on known or identifiable criteria relating to a borrower's internal operations or the underlying investments in the fund. KPIs at the investment level are increasingly more common in the market, due to their greater potential for material impact and lenders' focus on the subsidiarity principle; however, a KPI at the borrower level may be suitable if it otherwise satisfies the conditions in the SLLP. The borrower and the lender will work together to clearly identify KPIs and suitable SPTs:

- Where a KPI is tied to the fund's investments, it may be calculated as a percentage of investments that have stated goals meeting the specified criteria (thus incentivizing an increase in compliant investments over time).
- The KPI may also be applied to the operations of the individual portfolio companies holding the investments or based on appropriate impact metrics for the fund as a whole or a defined subset of the fund's activities (for example, the net reduction of the financed emissions of the fund).
- It may also be appropriate to incorporate gradual phasing of KPIs or to include eligibility concepts to define investments that will be included in calculation of the relevant SPTs, as the borrower continues to acquire investments or if the borrower requires the ability to hold an investment for a minimum period of time to reasonably effect change. As an example, a fund may need to hold an investment for at least a year to implement adjustments or other impacts; during this initial holding year a fund may not want the investment to count a non-compliant investment for purposes of calculating any required percentage or number of compliant investments. In tandem to this, lenders may also require that the borrower hold a minimum number of investments prior to being eligible for application of the pricing adjustment.
- Given the potential for relatively short tenored fund finance transactions with contemplated extension options, it may be appropriate to expand the SPTs out to the latest possible contemplated maturity, or it may be more suitable to anticipate reevaluation of SPTs once the facility has completed its initial term, being mindful that lenders should not contemplate a reduction in requirements absent compelling market or transaction specific circumstances.

As discussed in more detail in the SLLP, selection of appropriate and sufficiently ambitious SPTs is critical to maintain the viability of the SLL market. KPIs must be material to the borrower's core sustainability and business strategy and address relevant challenges applicable to the sector of the underlying investments. In situations where the borrower's ESG strategy or process for implementation of identifiable goals is not sufficiently advanced, where the borrower lacks the necessary expertise to oversee its strategy or if the borrower is not able to allocate sufficient resources to data collection, verification or reporting, it will not be appropriate to implement an SLL. Likewise, for funds that find SLL provisions to be burdensome or difficult to administer, it may be indicative of the fund not being sufficiently progressed to support an SLL. This could apply to many investment funds that are just formulating their ESG policies. In contrast, for funds that have advanced a sophisticated ESG policy, an SLL can align to its existing goals and objectives, making it easier to formulate suitable KPIs without the fund having concerns that provisions are restrictive or onerous.

A non-exhaustive, indicative-only list of KPIs used in the fund finance context is set out at Appendix 1 of this Guide (which examples are intended to be illustrative only and not an endorsement of any specific KPI, each of which should be independently formulated for each facility in accordance with the SLLP). External reference sources such as the Science Based Targets Initiative, ESG Integrated Disclosure Project, ESG Data Convergence Initiative, ICMA or the International Sustainability Standards Board may also help identify relevant and material KPIs for the specified industry or investment strategy. As noted herein, certain sectors may lend themselves to investments or projects that are focused on specific environmental or social impact (such as infrastructure, real estate or renewable energy), but such focus is not intended to prevent the application of KPIs to other sectors or industries where companies and investments are committing to improvements and contributions relative to their environmental or social footprint.

Calibration of SPTs

Market participants should carefully review the SLLP for guidance on calibration of SPTs. Though there may be differing approaches to the implementation of KPIs in fund finance transactions, in all cases the SPTs should be suitably ambitious and reflect the recommendations included in the SLLP including (a) material improvement in KPI beyond business as usual, (b) benchmarkable or comparable to an external reference, (c) consistent with the borrower's sustainability strategy, (d) generated through external guidance and discussions with any applicable sustainability coordinator and (e) following a pre-determined timeline.

In addition to comparisons to broadly accepted industry standards and references, the SLLP recommends benchmarking of SPTs based on historical performance and comparable peers within the relevant industry. In the context of fund finance transactions, it may be appropriate to refer to the historical performance of prior investment funds raised by the same sponsor entity or other similarly situated (by size and/or strategy) investment funds in the market (to the extent such information on other non-affiliated funds is publicly available and can be verified) to determine if the borrower's goals and anticipated performance sufficiently improve on prior or standard practice.

Loan Characteristics

See the LSTA's "*Drafting Guidance for Sustainability Linked-Loans*"[5] and the LMA's "*Model Provisions for Sustainability-Linked Loans*"[6] for standard provisions and drafting considerations for building SLL provisions and pricing adjustments into loan documentation.

Reporting

Per the SLLP, borrowers should provide reporting to the lenders as to monitoring of the SPTs at least annually (including information necessary to determine that the SPTs remain sufficiently ambitious) and include verification, as discussed below. Additionally, historical reporting, if any, should be provided to the lender during the initial negotiations and structuring of the transaction. Lenders may be able to refer to reporting that funds are providing to their investors, to the extent such reporting would otherwise meet the criteria set forth in the SLLP.

For investment level KPIs, the loan documentation needs to build in a process for initial and ongoing evaluation by lenders of investments and verification. In each case, this evaluation may require the provision of information on individual investments, and underlying data and criteria beyond what would be typical in a fund finance transaction (particularly in the context of a subscription line facility). The lender or sustainability coordinator should also have the ability to perform additional diligence as appropriate. Lenders and borrowers should agree upfront, and specify in the loan documentation, the type, nature, specificity, and granularity of data provided, so as to prevent disagreement during the course of the transaction.

Lenders and borrowers should also consider the timing of reporting. If the borrower is relying on reporting from its portfolio companies, this information may be delivered at different times throughout the year. Lenders should provide borrowers with a reasonable timeframe with which to collect and review information prior to delivery to the sustainability coordinator and lenders during each relevant reporting period.

Verification

The SLLP requires that borrowers obtain independent and external verification of each SPT for each KPI for any relevant period to assess performance. This is a necessary element of the SLLP and should be conducted by a qualified external reviewer with relevant expertise, such as an auditor (by way of limited or reasonable assurance, for example), environmental consultant or independent ratings agency.

For fund finance transactions with investment level KPIs, the external reviewer might evaluate the underlying investments to determine their alignment with stated environmental or other objectives identified in the borrower's investment policy or externally set benchmarks, policies, or goals, in each case to the extent forming the basis of the SPTs. As discussed above, this external review can result in significant costs for the borrower if it needs to commission third party reviews of reported data for a large number of investments; additionally, there may be logistical difficulties attendant to completing verification where information is difficult to obtain from portfolio companies or standardized metrics are not present. As proposed and codified regulations in many jurisdictions contemplate phasing in external audit and verification requirements, more standardized reporting may become the norm, which would make the external verification process more streamlined and accessible.

In order to address these challenges lenders, sustainability coordinators and borrowers should agree upfront as to the nature and scope of verification. For example, in circumstances where a significant amount of data is being provided by portfolio companies that are not controlled by the borrower it may be appropriate to utilize limited assurance whereby a third party evaluates the data provided by such portfolio companies on a limited basis and provides a negative conclusion (noting for example that there is nothing that has come to the reviewer's attention that would indicate a material misstatement in the data provided, but without a positive conclusion that the data is correct in all material respects).

See the *Guidance on External Reviews for Green, Social and Sustainability-Linked Loans*[7] for more information on the types of external review that can be carried out in relation to SLLs and the role of external reviewers.

Conclusion

The approaches identified above reflect strategies that have been adopted in the market but are not exhaustive of the means in which the SLLP can be adapted for fund finance transactions. Each transaction should be evaluated independently based on the ESG strategy, industry, and investment policy of the relevant investment fund. In each case, there must be sufficient information available on the proposed KPIs, SPTs or other sustainability metrics to ensure that the stated goals or relevant KPIs and SPTs are reflective of the intention of the SLLP to advance ambitious and credible ESG policies and goals.

5. https://www.lsta.org/content/drafting-guidance-for-sustainability-linked-loans-feb-17-2023/
6. https://www.lma.eu.com/documents-guidelines/documents/category/sustainable-finance#draft-provisions-for-sustainabilitylinked-loans222
7. https://www.lsta.org/content/guidance-for-green-social-and-sustainability-linked-loans-external-reviews/

Appendix 1 - Example KPIs in the fund finance context

Enviromental

Emissions Reduction

Reductions in greenhouse gas emissions associated with the investments being financed, which may be a percentage reduction or carbon intensity performance at the investment company level and/or fund level

Percentage of portfolio companies using science-based methodology to set up carbon reduction targets within a specified number of months following acquisition

Emissions Reporting

Percentage of portfolio companies reporting GHG emissions beyond minimum regulatory requirement, in line with the GHG Emissions Protocol Metrics disclosed in Annual ESG Reporting, aligned to reporting standards of Task Force for Climate Related Finance Disclosure or Sustainable Finance Disclosure Regulation

Percentage of portfolio companies adopting standard methodology for emissions reporting and reduction, such as SBTi Net-Zero Standard methodology

Renewable Energy

Percentage of investments focused on renewable energy infrastructure that meet specified criteria, such as energy output

Percentage of energy generation from renewable sources (including but not limited to, wind or solar)

Transportation

Percentage of investments focused on clean transportation infrastructure that meet specified criteria, such as research, manufacture, or circulation of clean transportation infrastructure or reduction in emissions from public transportation

Real Estate

Percentage of investments in real estate focused on sustainable construction or material improvements to energy efficiency that meet specified criteria such as percentage of emissions reduced compared to comparable buildings by virtue of building characteristics or construction design

Percentage of investments or real estate holding green building certification (such as a minimum LEED or BREEAM certification level)

Water & Waste Management

Percentage of waste from investments or operations recycled
Percentage of Investments focused on:

- Water collection saving, treatment, recycling, re-use, upgrades, technologies, and related infrastructure: including, but not limited to, anaerobic digestion of sewage, sludge, and bio-waste
- Activities that improve water and soil quality and increase water use efficiency: including but not limited to water treatment facilities and water metering
- Non-conventional waste management, disposal, and circular economy activities: including, but not limited to, source reduction, in-process recycling, reuse, sorting projects, resource recovery and treatment

ESG or Sustainablility Rating

Achievement of ESG Scores from a third party, reputable ratings agency, mutually agreeable to the lender and borrower

Social

Employee engagement, diversity and inclusion

Attainment of specific long-term goals relating to improvements in Diversity, Equity and Inclusion.

Stated goals related to diversity of leadership on the Board or senior management level beyond minimum legal/regulatory requirements.

Community Investments

Percentage of Investments meeting specified criteria for investment in low income or vulnerable communities, including access to essential services and other resources

Governance

Building strong corporate governance & transparency

Percentage, or number of, qualifying investments establishing ESG targets or goals, including goals relating to sourcing and directing of investments in line with external sustainability standards (such as alignment of infrastructure assets with an external low carbon reduction methodology)