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GREAT FUND INSIGHTS

Five questions on… sustainability-linked fund financing

Greg Brown Hello, welcome to this Allen & Overy podcast on sustainability-linked fund financing.

My name is Greg Brown, I'm the co-head of A&O's fund finance practice. In this podcast I am joined by Joanna Pecenik from our Luxembourg funds team to talk about sustainability-linked fund financing: what is it, what are the main EU regulatory drivers and what are the key issues that fund managers and lenders may need to consider when you are thinking about putting one of these loans in place.

Now, we've broken this session down into five key questions, so let's get started.

Joanna Pecenik The first question is for you, Greg. **Can you start by explaining what we mean by sustainability-linked lending in the context of fund finance?**

Greg Brown So, sustainability-linked loans are loans made to funds that have sustainability-linked performance targets included in the loan agreement. What this means is that performance by the fund borrower against objective external environmental, social or governance-linked metrics (so for example, carbon emissions reductions or hitting certain recycling targets) triggers a specified outcome or outcomes for the borrower under the loan, most commonly some form of margin adjustment.

Now, sustainability-linked loans are different from 'green' loans, because 'green' loans are loans where the use of the proceeds themselves is restricted to specified environmental or other 'green' projects. So, it's a loan that's drawn for a particular environmental purpose.

Both 'green' and sustainability-linked loans have certain things in common, which is that they are both structured to encourage sustainable and generally socially worthy behaviour but, while 'green' loans do this by requiring that the loan proceeds are used for a particular purpose, sustainability-linked loans do not have any restriction on the use of funds. What they do is that they include a set of sustainability-linked metrics that feed into the pricing of the loan. Those metrics can be set at the fund, at the asset or at the portfolio level and therefore they're a very flexible and achievable way for a wide range of fund borrowers to access sustainable financing; you don't need an underlying 'green' investment to put one of these loans in place, it can be an ordinary course financing that has these features built into it. What that means is that the adoption of these types of loans in the fund finance market has grown very quickly over the last couple of years and indeed, not just in the fund finance market, across the loans market more generally.

The rise of these loans in the fund finance market mirrors the increasing focus and the public pressure on participants in financial markets, from banks to fund managers to investors, to positively affect climate change, especially in light of COP26. As well as demand by investors for change, there is also new regulation that has been introduced in Europe, which sets ambitious targets in trying to re-orientate private capital towards more sustainable investments.

Which leads us neatly on to our next question, which is for you, Joanna. **Can you explain what are the key regulatory drivers in the EU towards sustainability-linked financing that investors and fund managers need to be aware of?**

Joanna Pecenik Besides purely commercial and reputational incentives for borrowers, there is a growing focus on ESG in the fund finance space due to the regulatory landscape in the EU and, more particularly, in the context of the European Commission's Action Plan on Sustainable Finance.

The most relevant EU regulation in this context is the Sustainable Finance Disclosure Regulation (also called the '**SFDR**'), which came into effect in March 2021.

The SFDR has imposed transparency and disclosure requirements on the so-called financial market participants such as banks, insurance companies, pension funds and investment firms and asset managers, both at entity and product level. The purpose of such requirements is to inform investors as to how such financial market participants implement ESG considerations and, more particularly, how they intend to integrate sustainability risks and adverse sustainability impacts in their investment processes and how sustainability-related information with respect to such financial products will be provided to such investors, including through periodic reporting.

In parallel with SFDR, the EU Taxonomy Regulation also entered into force in early 2020. The Taxonomy regulation provides for a classification framework which helps delineating what constitutes an environmentally sustainable financial product (in other words, to define what's 'green' and what's not) and it has set out criteria that needs to be met in order for a financial product to qualify as environmentally sustainable. The Taxonomy Regulation has been supplemented by delegated acts containing detailed technical screening criteria for determining when an economic activity can be considered as sustainable and therefore 'Taxonomy-aligned'.

Last, but not least, the Low Carbon Benchmark Regulation has recently amended the Benchmark Regulation, which contains uniform rules for low carbon benchmarks and positive carbon impact benchmarks in the EU by introducing two new types of "climate benchmark": the EU Climate Transition Benchmark and the EU Paris-Aligned Benchmark. The Benchmark Regulation applies to the provision of benchmarks, to the contribution of input data to a benchmark and the use of a benchmark within the EU, the latter being of specific interest for asset managers.

Now, how do those rules translate in the context of ESG–linked fund financing? Whether the ESG-linked facilities are use of proceeds facilities (which will require that all investments funded through loan proceeds meet specific sustainability criteria) or performance-based facilities (in which the borrower's performance will be measured against certain sustainability criteria), the '**KPI**'s or 'Key Performance Indicators' will be key and of particular relevance. The KPIs should be set out from inception upon implementation of the facility. Typically, in an ESG-linked fund financing, such KPIs and objectives will be aligned with the ESG and SFDR policies and objectives of the fund managers that the fund has implemented in accordance with SFDR and the Taxonomy Regulation. Such KPI's and objectives will also need to be assessed and reported periodically to investors in order to ensure compliance and again, fund managers should piggyback on the ESG disclosure and reporting obligations they have in place.

That brings us to the documentation. **Greg, what are some of the key issues that fund managers and their lenders need to consider when agreeing terms to document a sustainability-linked fund financing?**

Greg Brown

Right, so before we look at the detail, it's important to remember that this is still a relatively new product which is not yet highly regulated, so there are no 'strict' rules as such as to how sustainability metrics should be applied in loans or in loan documentation. Now, the **LMA** has issued various guidance together with the LSTA, and these include the Sustainability-Linked Loan Principles (**LMA SLL Principles**) and also the Green Loan Principles, much of which actually follows developments in the bond markets as well, but actually much of the detail does actually remain up to the parties on a given transaction to decide for themselves. That can be a good thing, because it allows people to be flexible; it encourages creativity as to how they are applied to a particular borrower, but it does also have the potential to create a lack of consistency and sometimes a bit of uncertainty as to how things like reporting standards and targets should be applied.

So, against this backdrop, the first point for a fund borrower to think about is what actually are the sustainability performance targets or '**SPT**'s they should be measuring? These targets, these SPTs, are at the heart of a sustainability-linked financing, they are normally unique for each loan and these need to be discussed and considered in the context of a fund's overall business and operations. Normally, the SPTs need to come from the fund and not be dictated by the lender because really it is the underlying investment strategy of the fund and what targets they themselves are seeking to implement within its business that are going to be key to the discussion here. Very often these targets will be environmental, so as I mentioned before, things like reduction of greenhouse gas emissions, energy consumption targets, water quality targets, bio-diversity targets are very popular. But it is important to remember that ESG isn't just all about the 'E', there are also non-environmental targets that get measured in loans as well, so again, to give a few examples, the number of female senior managers, focus on staff training, reducing internal food waste or payment of the London living wage, for example. As you can tell, there's a lot of scope for flexibility depending on a particular fund's own priorities.

It is important that the targets are meant to be ambitious; they are meant to be meaningful and they are meant to be a genuine stretch for the borrower. So the guidance from the LMA in their SLL Principles states that the SPTs should 'represent a material improvement in the respective KPIs and be beyond a "Business as Usual" trajectory'. Sometimes this is achieved by parties providing for incremental increases in targets over time, rather than just setting them at a constant level that applies for the life of the loan and obviously, this will depend on the expected duration of the financing and other features like that, you know; how long are these targets going to be in place for?

Now I think the unique challenge for fund financing is how you set and decide on appropriate and properly challenging KPIs and sustainability performance targets at a portfolio level for a financing which is often put in place very early in the life of a fund, so perhaps at a stage where they've made few or no investments at all, so effectively, when you've just got your fund vehicle, how you work out what those targets should be. And what can be helpful is, you know, previous fund performance on similar metrics can inform the process, but we are often seeing parties seek flexibility in the documentation to review the KPIs and perhaps amend them as time goes on. So, for example, you might include a requirement to review the KPIs every 12 months, just to make sure that they do remain sufficiently appropriate and sufficiently challenging and perhaps for those KPIs to be amended if the relevant lenders consider that the targets are no longer relevant or the science behind them has changed or, you know, something else means that they are just no longer quite fit for purpose. Sometimes, a flexibility parties look for is an ability for either the borrower or the lenders to bring the parties back to the table just to discuss those certain KPIs if they feel they are just no longer appropriate, maybe with a right to then switch off that KPI if agreement cannot be reached on any necessary amendments. So, in this context, what you can see is that it's really important for the funds to be clear about what is being measured; they need to be part of that conversation, they don't want their lenders to be dictating to them what they think is appropriate or not. It is very important to consider whether those KPIs should be assessed on a portfolio basis looking across all of the investments of the fund, at the fund level itself or sometimes on an individual investment-by-investment basis, and again that's going to depend on the choice of the targets and the choice of the KPIs.

Greg Brown

What this brings us on to actually, is to consider the reporting and the verification obligations of the fund in the documentation, as clearly these sustainability targets are only as meaningful as the quality of the reporting that is actually made against them. The question on reporting is really whether the reports produced by the fund itself are going to be sufficient evidence for the finance parties to measure the SPTs, whether there needs to be some sort of audit of that internal reporting or does there need to be some sort of active third party engagement to provide an independent report? And there's going to be a number of factors that will feed into that discussion; clearly, whether the fund itself has an existing reporting process, or an existing ESG framework that it reports against, what are the types of the underlying investments, you know, are they inherently things where these sorts of targets are captured and measured, and probably some sort of cost/benefit analysis as to the value of a further report. The type of KPI is also an important factor in working out what sort of reporting is appropriate, because you can see that targets such as, say, increasing the number of female senior managers are relatively easy for a borrower to certify and provide evidence for, whereas a more technical environmental target such as a greenhouse gas emission will almost certainly require a degree of external validation. So, for this reason, we do sometimes see a mix of external verification or validation and sometimes some self-certification as well, very much depending on the targets that are set. However, it is important to note that the LMA SLL Principles on this and the related guidance notes do provide very strong recommendations that there should be some form of 'independent and external verification' of the borrower's performance against KPIs at least once a year and I think most banks do have some sort of expectation that that needs to be part of the package.

Another key point for both sides to consider is: what are the margin adjustments or incentives that you're building into the loan to hit these targets? It's probably fair to say that margin adjustments tended to start out just as a one-way simple discount so that when the fund hit the relevant targets or enough of the targets they'd get the benefit of a slight reduction in their margin. I think it's fair to say now that we tend to see margin adjustments most commonly included as a ratchet and on a two-way basis, so that again, if they meet their target they get a discount, but if they don't meet the targets, the margin will normally increase. These changes are not normally substantial in terms of the quantum of the pricing, you know, it's not the sort of thing that really blows the pricing one way or the other, but nonetheless it obviously has a real economic impact on the parties. And I think recently, you sometimes see a discussion around what should happen to the pricing if the borrower or lender gain as a result of a target being hit or not hit; you know, is it right that the lender gets the benefit of an uplift in margin? Sometimes, you have a discussion about whether these sorts of savings should go to a charity, for example. I think that's relatively unusual, but important to note that sometimes people think about that aspect of it as well.

And then related to the discussion on pricing consequences is: what happens if the fund does fail to meet the targets or simply fails to deliver the relevant report? I think it's fair to say that the standard position we almost always see is that failure to hit the target or the failure to provide a report does not trigger an event of default, you know, doesn't give rise to an actual breach of the contract. What it does normally just mean is that it has a pricing consequence, so the failure to hit the target or deliver the report impacts on the margin premium or gets rid of the margin discount that would otherwise apply. The consequences don't normally go further than that, so it's important to note that a fund borrower would not normally be able to actually place itself in default under its financing arrangements for failing to hit one of these targets.

Greg Brown And then I think the last point just to note is to look briefly at the role of the lender, who may undertake what's called the 'Sustainability Co-ordinator' role on a deal, which I think is getting more attention in documentation now as I think lenders are increasingly aware of the potential liability perhaps that goes with this role, whether legal or reputational. An obvious concern is a lender who does help structure these targets and works with a borrower to set out a set of SPTs for a given loan, if it subsequently becomes revealed that perhaps that underlying information was flawed or manipulated in some way, query if the Sustainability Coordinator is in the firing line for criticism or action around that? And I think as a consequence, it's fair to say it's much more standard now for documentary protections to be included for the Sustainability Coordinator in the loan agreement in a similar way that you would see, for example, for an arranger or someone else with a 'role' under a loan.

Joanna Pecenik Speaking of lender protections, greenwashing is obviously very topical in the market at the moment, given some of the recent and ongoing investigations by regulators into potential prospectus fraud and misleading statements made by fund managers in relation to their 'green' credentials. 'Greenwashing' is described in the EU Taxonomy Regulation as the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met. But the term can be also used in a more generic sense to suggest that a product or service has or is provided by a firm that has certain ESG credentials, when it doesn't. **So Greg, do you have any thoughts on how parties in sustainability-linked financings can look to protect themselves from accusations of 'greenwashing'?**

Greg Brown Yes, so there are some strategies that the parties can have in mind to help avoid suggestions of greenwashing. So I think some things to think about are:

– obviously, you make your KPIs clear and easy to understand. Make sure they are specific, with specific units of measurement and, if available and appropriate, with third party certifications or endorsements, and they should be credible third parties: either proper sustainability advisers or auditors of some kind. So, statement of the obvious, but those KPIs need to be proper KPIs, credible KPIs;

– the second point is related to that really, which obviously is the reporting that goes around that needs to be transparent and very accurate, and this needs to be set out clearly in the documentation, again ideally with agreed data and metrics to back it up and that needs to be complied with by the parties, so again so you are comfortable you are getting fair and meaningful measurements against each SPT; you don't want to leave scope for a concern about whether these are being 'gamed' in any way;

– the targets that are set need to be realistic and ambitious. You don't just want to be paying lip service to the idea of a sustainability-linked financing, you do need to be setting a goal that you can show has some sort of positive impact and that the loan is helping to incentivise or steer the borrower's business in meeting those targets. So, as I say, those targets need to be credible; what you do not want to be setting is targets that the borrower would almost certainly have met without doing anything, just on a 'business as usual' model; they need to be stretching the borrower in some way; and

– I think lastly, it is just a question of thinking about the big picture; if the sustainability SPTs are met, but actually in the wider context of the fund's business, sustainability doesn't really play any part or those targets are completely unrelated to what actually the business is doing as a whole, then you've probably set the wrong targets. You know, it does need to actually have some sort of connection with the fund's business, so think about it on a kind of holistic basis, don't just think about it in terms of ticking the box in a loan document.

Greg Brown And I think it's important to stress that the loan markets generally are becoming much more alive and I think concerned about the issue of greenwashing, and we are starting to see additional provisions around reputational and legal risk making their way into loan documentation. We've mentioned the point about the additional protection for a bank who undertakes the Sustainability Coordination role but we do sometimes see additional provisions on top of that as well, so occasionally we've seen lenders seek provisions to deal with what are called significant or severe 'controversy events', the idea being that if there is some sort of unexpected but adverse event that has a sustainability impact on the borrower, then that has the ability to switch off the sustainability-linked metrics. So it's almost thinking about it like an ESG material adverse change almost, but the idea is that it gives the lenders the ability to switch off the sustainability-linked metrics because of some sort of wider sustainability-linked concern. I mean, it's essentially an anti-embarrassment mechanic for a lender, but it does help address the risk of greenwashing. Having said that, it's worth saying that from a borrower's perspective, it's obviously unattractive, because what it does is give the lender a bit of a free pass to switch off the mechanic, perhaps without clear objective criteria. So it's fair to say we see them occasionally, but by all means not on every deal.

The other emerging provision that we see to address this greenwashing risk is the inclusion of so-called 'declassification' events, and the idea here is that if a loan ceases to meet the criteria for a sustainability-linked loan, perhaps because the borrower has failed to bother to report or, you know, the lenders' own requirements have changed, then the declassification event kicks in and effectively the parties agree that they will collectively no longer report this or publicise this as a sustainability-linked loan. And again, the real purpose there is really to protect the lenders from a loan being presented as meeting certain criteria when actually, the parties have decided that's no longer the case, so this is again trying to address that risk of greenwashing.

Joanna Pecenik Thanks very much for that Greg. **Last question: what do you see on the horizon for sustainability-linked fund financing?**

Greg Brown OK, I think from the direction of travel at the moment, it's clear we're going to see continued collaboration between investors, GPs and lenders across different types of facilities, really to continue with the growth of sustainability-linked loans in this particular market. I think there's going to be a degree of increasing standardisation as people become more familiar with how it works and there is, you know, still a lot of potential for the use of these products to grow.

I think we'll see perhaps an increasing growth of actually 'green' and use of proceeds loans in this space as well. Again, it's going to depend on the type of fund and depend on actually their underlying investments, but it seems to me that there's scope for that to develop in the fund finance space as well.

Despite the recent bumps in the ESG road, I think fundamentally, there's still strong demand for these products across the board, and this was recognised in the publication of the LMA Social Loan Principles (SLPs) as well last year, which again just shows the slightly ever expanding universe of these types of product. So I think there's going to be some bumps along the way, but I think sustainability-linked and green financing is clearly with us and certainly is going to continue to grow in the fund finance space.

Greg Brown So that brings us to the end of our five questions on sustainability-linked fund financing. Thank you again to Joanna.

Joanna Pecenik Thanks Greg.

Greg Brown And as always, please do contact us if you'd like to know anything more about any of the issues we've raised in today's podcast, and thank you again for listening.

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