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FUND FINANCE FRIDAY

# ESG Loans – The Next Big Wave in Fund Finance

March 19, 2021 | Issue No. 118

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There has been a dramatic increase in appetite amongst funds for sustainability linked loans (SLLs), which are often commonly referred to as “ESG linked loans” or “KPI loans,” an appetite that is expected to continue to increase in the coming years. This article provides an outline of SLLs, as well as some key structuring considerations.

***What are SLLs?***

SLLs are loans that incentivize the borrower’s commitment to sustainability through predetermined sustainability performance targets (SPTs) that are measured by using key performance indicators (KPIs). When these KPIs are met, the borrower may receive the benefit of a discount in its loan pricing. This is not always the case. In certain circumstances where a discount is provided, the parties may elect to donate such discount to environmental charities or to other environmental, social or governance (ESG) purposes or projects.

***Are SLLs the same as Green Loans?***

SLLs are not the same as green loans. Green loans must be used to finance green projects, whereas the use of loan proceeds is not a determinant for SLLs, although it is possible for a SLL to also be a green loan.

***Why are borrowers interested in SLLs?***

Companies today are increasingly devising sustainable, diversity and green strategies, which inevitably form part of the financing criteria. SLLs help to achieve these objectives by holding the fund in question accountable and offering greater transparency to investors. Borrowers and lenders can also benefit by building stronger value-based relationships with investors/funds that

value ESG investing, and both parties can also benefit from a positive reputational impact as advocates of such ESG goals.

***Setting the SPTs and KPIs***

Borrowers and lenders will negotiate the SPTs and KPIs and, typically, a “Sustainability Agent” or “Sustainability Coordinator” will be appointed and will lead negotiations on behalf of the lender group. While there is no market standard for SPTs, the SPTs will be linked to one or more ESG considerations that support the borrower’s existing sustainability strategy. General examples of SPT categories include board diversity, healthy living environment, and low carbon emissions.

When determining the SPTs and KPIs, it is important to consider the following:

(1) *The life of the loan*

SPTs should apply for the life of the loan, and so it’s important to therefore consider how long the loan is when determining the achievability of the SPT. Depending on the life of the loan, the parties may wish to set the KPIs on an incremental basis, or, alternatively, the parties might wish to include a mechanism whereby the KPIs can be revisited periodically to assess their suitability.

(2) *The amount and complexity of KPIs*

While it is extremely important to properly monitor and measure the SPT through the use of KPIs, consideration should also be given to the administrative burden on the parties if using multiple and/or complex KPIs. Quality over quantity is preferred. If multiple and/or complex KPIs are being used, a third-party reporter may be preferable, if such third party has knowledge of the complexities involved and/or is better placed to properly monitor the KPIs.

(3) *Reporting obligations*

Borrowers should report on the SPT at least once a year, and the parties should also consider whether more frequent reporting is required based on the nature of the SPT. SPTs can be internal and defined and reported on by the borrower, external and assessed by an external reviewer, or a combination of both. When determining who is better suited to report on the KPIs, it is important to consider the following:

- *Existing reporting requirements and practices of the fund*

The parties should ascertain the existing practices of the fund, and the existing reporting requirements, and whether the fund in question is better placed and able to provide sufficient detail in such reports. There may already be existing synergies that the parties can avail themselves of.

- *Cost/benefit of external reporting*

If third-party reports are to be obtained, the costs associated with obtaining such reports should be weighed against the margin reduction that would be obtained from the SLL.

- *External metrics*

Depending on the nature of the SPT, there may be an external metric that can be used to measure the SPT. For example, for an environmental-related SPT, the Paris Agreement provides existing regulatory targets with which the fund may wish to align.

***What happens if a fund fails to meet a KPI?***

The failure to meet a KPI will result in an inability to access the incentivized discount, and typically won't result in an event of default. The pricing triggered by such failure will typically apply until the next pricing adjustment date of the loan, and if the KPI is satisfied on the subsequent reporting date, the pricing will then be discounted on the subsequent pricing adjustment date. It is common for an event of default to be triggered from misrepresentation in the reporting related to KPI compliance, particularly where there is an element of fault on the part of the borrower for such misrepresentation. Such events of default can also act as deterrents against sustainability washing.

***What is sustainability washing?***

Sustainability washing is a term used where the sustainability credentials in question are inaccurate, misleading or exaggerated, and can occur, for example, when fund managers make exaggerated claims about their ESG credentials in an attempt to muscle in on the market. To avoid sustainability washing, funds should ensure that they are transparent, and, in particular, that the SPTs are adequately ambitious and meaningful and that they are adequately monitored and reported. Negative reputational impact or a serious undermining of this product are some of the main risks associated with sustainability washing.

***Closing remarks***

In light of the events of 2020 (worldwide protests against institutionalized racism, the COVID-19 pandemic and social crises, and the environmental catastrophes triggered by global warming), it's only natural that socially conscious investing is gaining more and more momentum. Quite simply, SLLs incentivize funds to achieve their ESG goals while, at the same time, providing greater transparency to investors and greater accountability within. While at a nascent (but burgeoning) phase at the moment, we expect SLLs to become part of the common landscape in Fund Finance going forward.