

Sustainability Linked Loans and Fund Finance

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In the current political and environmental climate, the topic of sustainability and climate change has, literally and metaphorically (!), become a 'hot' topic. This issue has permeated almost every industry and political agenda, with the provision of finance being no exception.

In March 2018, the Loan Market Association ("**LMA**") published its 'Green Loan Principles' (the "**GLPs**"), which aimed at creating standardisation across the wholesale green loan market. The GLPs were born out of the findings of the Global Green Finance Council (the "**GGFC**"), and the trend to align the finance industry with green and environmental principles has continued with the LMA's recent publication of the 'Sustainability Linked Loan Principles' ("**SLLPs**"). The GGFC was itself founded in 2017 to bring together key associations operating in the green finance space. Founder members of the GGFC include the LMA, the Global Financial Market Association, the International Capital Market Association, the European Banking Federation, the European Covered Bond Council, the Institute of International Finance and the World Federation of Exchanges.

In this article we will focus on sustainability linked loans, why the need for them has arisen, and their potential impact on the fund finance industry.

Green Loans and Sustainability Linked Loans

The terms 'green loans' and 'sustainability linked loans' are often used interchangeably but they actually refer to two very distinct products. 'Green loans' are loans which are provided to a borrower for a 'green' purpose, i.e. the proceeds of the loan must be applied towards an environmentally friendly project. Green loans may be used to finance energy efficient projects, such as wind farms or sustainable fisheries. On the other hand, 'sustainability linked loans' do not need to be applied to an environmentally friendly purpose. Rather, sustainability linked loans are not concerned with the application of the proceeds of the loan, and many may be applied for general working capital purposes. A sustainability linked loan links the lender's pricing to the borrower's sustainability performance, meaning that the margin will be adjusted throughout the lifetime of the loan based on the borrower meeting certain pre-agreed sustainability criteria. The pre-agreed criteria will depend on the nature of the borrower's business, and can range from anything such as the percentage use of recyclable materials, to the energy efficiency of buildings that the borrower group occupies.

Global Pressure for Sustainable Finance

At a climate conference in Paris in December 2015, 195 countries who are party to the United Nations Framework Convention on Climate Change entered into a legally binding agreement for a global action plan aimed at reducing global warming (the "**Paris Agreement**"). One of the goals included in the Paris Agreement was a commitment towards "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development" (Article 2.1(c) of the Paris Agreement). The intention of this article was to bring into focus the use of private finance as well as public finance. The ultimate aim of the Paris Agreement was to keep global warming to below 2°C this century. In order to achieve this aim, the Organisation for Economic Co-operation and Development estimated that \$6.9trillion of annual investment in transport, energy and

water infrastructure would be required over the next 15 years. Public funds would not be sufficient to meet this target, and as such it is crucial that private funding engage in the same initiative.

In December 2016 the European Commission (the “**EC**”) established a ‘high-level expert group on sustainable finance’ (“**HLEG**”). The HLEG was made up of a mixture of experts from the finance industry, academics and civil servants. The HLEG was instructed to provide advice to the EC on how the finance industry in general could become more environmentally friendly, including steering the flow of public and private capital towards sustainable investments and identifying steps that can be taken to protect the stability of the financial system from environmental risks. Based on the findings of the HLEG, the EC published certain recommendations for a sustainable finance industry in March 2018. The actions points for the finance industry included:

- establishing a clear and detailed EC classification system for sustainable activities in order to provide a common understanding of what was considered sustainable throughout the finance industry. This included proposing the regulation on the establishment of a framework to facilitate environmentally sustainable investment (the “**Proposed Taxonomy Regulation**”);
- establishing ‘green’ labels for finance products which comply with green or low-carbon criteria;
- clarifying asset managers’ and investors’ duties regarding sustainability;
- strengthening the transparency of companies on their reporting requirements in relation to their environmental, social and governance policies (“**ESG Policies**”);
- incorporating climate risks into lenders’ risk management policies; and
- supporting lenders that contribute to the financing of sustainable projects.

In March 2019 the EC held a second high-level conference for 27 EU countries on sustainable finance, with the objective of encouraging a global approach to sustainable finance. The conference focused on the need for international coordination in relation to financing sustainable global growth, and deploying private capital towards sustainable investments. In the same month the LMA published the SLLPs.

ESG Policies and Investment Funds

Following global political pressure for more environmentally friendly investment, certain amendments were proposed in 2018 to existing regulations (including the UCITS Directive, the AIFM Directive and the MiFID II Directive) to clarify how asset managers, insurance companies, and investment and insurance advisors should integrate sustainability risks by adopting new delegated acts in order to include ESG considerations into the advice that investment firms and insurance distributors offer to clients.

Off the back of the Proposed Taxonomy Regulation, the EC went on to propose regulation on the establishment of a framework to facilitate sustainable investment and disclosure in relation to suitability risks and sustainable investments, including:

- the regulation of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector (the “**Disclosure Regulation**”); and
- the regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards the EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (the “**Low Carbon Benchmarks Regulation**”).

The first disclosures under the new Disclosure Regulation will need to be made by the end of 2020, with the remainder of the rules taking effect the following year. The Low Carbon Benchmarks

Regulation is already in place and the Proposed Taxonomy Regulation is expected to be adopted by the end of 2022. Investment funds will need to consider what was previously a voluntary ESG regime and check that they are in compliance in fairly short order.

In June 2019, the Institutional Limited Partners Association (“**ILPA**”) published its 3.0 Principles on “Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners”. The “Notification and Policy Disclosures” principle encourages GPs to consider maintaining and updating an ESG Policy, and states that such ESG Policy should be provided to LPs upon request. ILPA also encourages GPs to demonstrate their commitment to ESG by adhering to industry standards, such as the United Nations-supported “Principles for Responsible Investment”.

For some time funds have been looking at how they can stand out from competitors and offer high returns which are also socially conscious due to increasing investor interest in making ‘green’ investments. BlackRock (the world’s largest fund manager) is the latest institutional investor to sign up to Climate Action 100+. Climate Action 100+ is an investor initiative aimed at encouraging the largest corporate greenhouse gas emitters globally to take action to reduce their emissions and make a transition to clean energy. Other large institutional investors who have signed up to Climate Action 100+ include Varma Mutual Pension Insurance Company, APG, MN and Ontario Teachers’ Pension Plan. BlackRock also recently announced that it plans to increase its holding of sustainable assets by up to ten times by 2030, whilst also divesting from companies that receive over a quarter of their profits from fossil fuel.

LMA’s Sustainability Linked Loan Principles

As mentioned above, sustainability linked loans are intended for broad use in the market and such a loan can be used for general corporate purposes. To be categorised as a sustainability linked loan, the LMA’s SLLP’s focus on four main areas:

- *Relationship to Borrower’s Overall Corporate Social Responsibility (“**CSR**”) Strategy:* the borrower should clearly communicate its CSR policy to its lender and how this ties in with its proposed sustainability performance target (“**SPT**”);
- *Target Setting – Measuring the Sustainability of the Borrower:* the borrower’s SPT should be negotiated between the borrower and the lender. The borrower may appoint a third party agent to assist the borrower with negotiating its SPT. SPTs should be based on recent performance levels, but also be ambitious. The main aim of a sustainability linked loan is to improve the borrower’s sustainability profile;
- *Reporting:* the borrower should keep up to date information in relation to its SPTs, which such information being provided to the lender at least once per annum. Depending on the nature of the borrower, borrowers are encouraged to publicly report this information and include any data relating to its SPTs in its annual report. It may not be appropriate for certain borrowers to make this information publicly available, in which case such information should be provided to lenders only;
- *Review:* where a borrower does not publish information publicly, it may be appropriate to appoint a third party to conduct an external review. In such cases, an external reviewer, such as an auditor, rating agency or environmental consultant, will review the borrower’s performance against its SPT.

Recent developments in the finance industry have continued to support the call for sustainable finance, with the International Platform on Sustainable Finance recently launched in October 2019 following the International Monetary Fund’s and World Bank’s annual meeting. High profile

borrowers help encourage the appetite for such loans, with fashion house Prada being the latest of such borrowers to advertise its use of a sustainability linked loan.

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In addition to their ESG Policies, one area where funds can also demonstrate their commitment to supporting environment endeavours is by setting ambitious SPTs and working with lenders to achieve these targets, whilst at the same time hitting thresholds which ensures a lower interest bearing loan. Sustainability linked loans are therefore not only benefitting the planet, but are in the best interests of investors who are looking to put their money to good use whilst obtaining the lowest possible interest rate on their debt repayments. In turn, lenders have their own ESG Policies (which bank regulators are paying more and more attention to) and are ultimately answerable to their shareholders, and with the global shift towards responsible investment the offering of such products can only be seen as good for business.

ING recently publicised its provision of a sustainability improvement capital call facility to a Singaporean based private equity fund in what is believed to be the first facility in the world to link the interest rate to the sustainability performance of the fund's portfolios, and it is thought many more will follow. With the recent wildfires devastating Australia demonstrating the physical impact of climate change on our planet, the need for investment in environmentally friendly projects (with the support of green loans) and a move towards greener investment policies (with the additional incentive of lower pricing which sustainable finance can offer) could not be more urgent. Watch this space!