UPDATE

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

Introduction

Some of our recent updates have covered Loan Market Association ("LMA") guidance in relation to sustainability[1]. Environmental, social and governance ("ESG") issues continue to be a focus for investment funds, and investors are increasingly looking at a fund's strategy and agenda regarding ESG in making investment decisions.

In March 2024 the LMA published a new guide (the "Guide")[2] aimed at providing practical guidance on the application of the sustainability-linked loan principles ("SLLP")[3] to fund finance transactions. The Guide identifies challenges and considerations that may arise and discusses how the SLLP can best be utilised in the fund finance market.

Differentiating between green loans, social loans and SLLs

Green and social loans require that the proceeds are used solely to finance (i) green projects or investments or (ii) investments with a specific social impact. By comparison, the proceeds of sustainability-linked loans ("SLLs") can be used for any specific or general corporate purpose.

SLLs work by using commercial or economic terms to achieve sustainability performance targets ("SPTs"). As a result, structuring a fund finance transaction as an SLL affords the most flexibility.

Challenges

Even where a fund has a sophisticated strategy that applies ESG considerations to its investment decisions and/or operations, challenges can arise.

The Guide notes that these challenges are not insurmountable and that a lender's individual assessment remains key in determining whether a particular borrower qualifies for an SLL.

The nine most notable practical challenges outlined in the Guide are:

Challenge 1: the borrower will often have been recently formed, with limited data available.

Challenge 2: it can be difficult to identify the requisite key performance indicators ("KPI") where the borrower has limited structural operations.

Challenge 3: the uncertainty and closed nature of a fund's planned investments make assessing a KPI or SPT impractical, with a risk of inconsistency in application.

Challenge 4: the implications of SLL requirements may extend beyond the requirements of investors.

[1] https://maples.com/en/knowledge-centre/2024/02/lma-publishes-external-review-guidance-for-green-social-and-sustainability-linked-loans; and https://maples.com/en/knowledge-centre/2023/11/lma-guide-to-sustainability-linked-leveraged-loans

[2] https://www.lma.eu.com/application/files/4417/0963/8357/A_Guide_to_the_Application_of_the_SLLP_in_Fund_Finance.pdf (in conjunction with the APLMA, FFA and LSTA)

[3] Sustainability Linked Loan Principles (SLLP) - LSTA

Challenge 5: verification processes can be impeded by the variety and volume of investments.

Challenge 6: where the fund does not control the investment portfolio, it can be difficult to ensure the provision of a sufficient level of data to enable assessment of compliance with an SPT.

Challenge 7: where a suitable KPI or SPT cannot be adequately identified, a green or social loan may be deemed more appropriate than an SLL.

Challenge 8: fund finance transactions often have a short term of one to three years, which can make gathering sufficient information to qualify for an SLL more difficult.

Challenge 9: the application of sustainability principles varies based on the relevant market and applicable regulations.

Notwithstanding the presence of one or more of the above considerations, lenders and borrowers may conclude that the incorporation of SLL provisions is not precluded, so long as the proposed transaction is administered in accordance with the SLLP.

Selection of KPIs

The Guide states that, in order to maintain the integrity of the SLL market, the selection of KPIs and the 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 those necessary to meet legal or regulatory requirements.

In the context of a fund finance transaction, these KPIs may be set at borrower level, but investment level KPIs are increasingly more prevalent in the market.

The Guide sets out some options for KPIs in the context of fund finance transactions, including the following:

(a) calculating them as a percentage of investments with stated goals meeting specified criteria (where a KPI is tied to a fund's investments) in order to incentivise an increase in investments meeting those criteria;

(b) tying KPIs to impact metrics for the fund as a whole, or to a defined subset of the fund's activities, or to the operation of portfolio companies holding the investments;

(c) gradually phasing them to define investments that will be included in the 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, time to reasonably effect change; and

(d) if term extension options are contemplated for a facility, extending the SPTs to the latest possible contemplated term, or anticipating recasting the SPTs once the initial term has expired.

To assist with the selection of KPIs, Appendix 1 of the Guide provides a non-exhaustive list of examples of KPIs used in fund finance transactions.

Calibration of SPTs

The Guide notes that SPTs must be "suitably ambitious" and satisfy the recommendations in the SLLP, such as:

(a) generating material improvement in KPIs beyond business as usual;

(b) being comparable to an external reference or benchmark;

(c) consistency with the borrower's sustainability strategy;

(d) be generated through external guidance and discussions with an applicable sustainability coordinator; and

(e) following a pre-determined timeline.

The SLLP also recommends assessing SPTs based on "historical performance" and "comparable peers in the relevant industry".

In a fund finance transaction, this may involve a review of investment funds under the same sponsor entity to determine the suitability of the borrower's objectives and projected performance.

Verification and Reporting

The Guide emphasises that the ESG strategy, industry and investment policy of an investment fund form an important part of the assessment of whether a loan complies with the SLLP.

As noted above, a common obstacle to this is a lack of available information about such a fund, but each loan must still be assessed on an individual basis.

The SLLP recommend that reports on SPTs be made to lenders on an annual basis. For an investment level KPI, a mechanism for initial and continuous assessment by the lender should also be included.

The Guide suggests that all reporting mechanics and requirements should be agreed during the negotiation of the loan.

Conclusion

Given the unique challenges faced by investment funds, the Guide is a welcome addition to the LMA's sustainability guidance.

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