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KEY POINTS
- The Loan Market Association, Asia Pacific Loan Market Association, Loan Syndications and Trading Association and the Fund Finance Association recently published a guidance note (Guide) on the application of the Sustainability Linked Loan Principles (SLLP) in fund finance.
- The Guide provides practical advice to market participants on how the SLLP can be used to structure sustainability-linked loans in the fund finance market, as well as identifying and addressing challenges and considerations particular to these types of transactions.
- In this article the authors consider strategies that the market has adopted to address relevant concerns.

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Fund finance and sustainability: new guidance on the application of the SLLPs

Over recent years there has been significant growth and development in the fund finance industry, which has expanded over the last decade into a global market now worth more than US$600bn, according to asset manager abrdn. As the market has continued to mature, the variety of tools available to investors (which include private equity, private credit and venture capital) to fund their operations has expanded considerably beyond the traditional subscription facility to encompass many more types of fund financing. One such innovation has been the introduction and adoption of sustainable finance, either by way of use of proceeds facilities (green loans) or sustainability-linked loan facilities.

In light of the increased use of ESG-linked financing in the fund finance market, on 5 March 2024 the Loan Market Association, Asia Pacific Loan Market Association, Loan Syndications and Trading Association and the Fund Finance Association published 'A Guide to the Application of the Sustainability Linked Loan Principles in Fund Finance' (Guide), which provides practical guidance to market participants on how the Sustainability Linked Loan Principles can be used in the fund finance market, as well as identifying and addressing challenges and considerations particular to fund finance transactions.

In this article we will examine the use of sustainability-linked financing in the fund finance market and consider some of the issues raised by the Guide.

BRIEF OVERVIEW OF TYPICAL FUND FINANCING FACILITIES

As the fund finance market continues to evolve, there has been an acceleration in the development of various new financing products, moving from straightforward bridging facilities to increasingly sophisticated tools and, in some instances, hybrid instruments. For the purposes of this article, we will briefly consider two types of facilities – the subscription credit facility (also known as "capital call" or "equity bridge" facilities) and the net asset value (NAV) facility – both of which have, in recent years, incorporated ESG-linked pricing adjustments.

Subscription lines of credit are loans usually taken out by closed-end private market funds, which enable the fund manager to make investments quickly without the need for irregular capital calls from the fund's investors. The lender looks to the uncalled capital commitments of the fund's investors (ie the amount the investor has committed to the fund which has not already been subject to a capital call) and the security package includes the capital call rights of the general partner and the account(s) into which capital calls are funded, without recourse to the underlying investments in the fund.

NAV facilities allow investment funds to borrow based on the value of their portfolio investments, providing them with flexible and efficient access to additional capital. Such facilities may be the preferred option in various scenarios, for example, when the undrawn investor commitments are depleted, or when the investment period has ended, and additional liquidity is needed for follow-on investments. NAV facilities are secured by the assets or actual investments held by the fund or the equity interests in the vehicles that hold such investments. See Table 1 overleaf.

QUICK RECAP OF THE SUSTAINABILITY-LINKED LOAN PRINCIPLES

The Sustainability-Linked Loan Principles (SLLP) were first published by the Loan Market Association (LMA), Asia Pacific Loan Market Association (APLMA) and Loan Syndications and Trading Association (LSTA) in May 2018. These voluntary principles were developed in collaboration with leading financial institutions, borrowers, and other stakeholders to provide guidance and best practices for structuring sustainability-linked loans (SLLs). Since their initial publication, the SLLP have been updated to reflect current market practice and they are widely recognised and adopted across the financial industry (including in the fund finance market) as a framework for promoting sustainable lending practices. The SLLP comprise the following five core components:

- **Selection of KPIs**: Key Performance Indicators (KPIs) are fundamental to the credibility of the SLL product, therefore the negotiation and selection of robust KPIs is of utmost importance. The SLLP require that KPIs be relevant, core and material to the borrower's overall business, and of high strategic significance to the borrower's current and/or future operations. In addition, they should be quantifiable using a consistent and methodological process and, where possible, capable of benchmarking against an external reference.

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- **Calibration of SPTs**: the calibration of the Sustainability Performance Targets (SPTs) per KPI is the principal indicator of a borrower's level of ambition in terms of its sustainability improvements. The SPTs must remain relevant and ambitious throughout the life of the facilities and should envisage improvements that go beyond both a "business as usual" trajectory and regulatory required targets. Ideally, they should be consistent with the borrower's overall sustainability strategy, capable of benchmarking (which may be against the borrower's past performance, against its peers' performance, by reference to science, or a combination of these) and governed by a predefined timeline, set before or concurrently with origination of the loan.
- **Loan Characteristics**: this component simply requires that an economic outcome is linked to the relevant SPTs, which in the SLL market usually takes the form of a margin ratchet. The precise nature of the pricing adjustment is credit specific and subject to negotiation between the borrower and lenders, but it will often be a two-way ratchet.
- **Reporting**: robust reporting mechanisms are key to tracking the borrower's progress towards meeting its SPTs. Regular and transparent reporting ensures accountability and provides stakeholders with visibility into the borrower's sustainability performance and the SLLP require that borrowers provide the lenders with sufficient up-to-date information for them to both monitor performance and ascertain that the SPTs remain ambitious and relevant to the borrower's business on an at least annual basis.
- **Verification**: requires independent, external verification and review of the borrower's sustainability performance data for the relevant period by a qualified reviewer (often an auditor or environmental consultant) to ensure accuracy and credibility. The independent review mechanism enhances transparency and trust among lenders, investors, and other stakeholders and ensures the integrity of the SLL product.

TABLE 1:

	SUBSCRIPTION FACILITY	NAV FACILITY
STAGE OF USE DURING FUND LIFE-CYCLE	Inception	Once sufficient assets are held in the portfolio
STRUCTURE	Typically take the form of an RCF	Flexible
TENOR	Bridging facilities and therefore short term, with a tenor of between 1 and 3 years	Flexible, but generally longer tenor than a subscription facility. When structured as a term loan the tenor will range from 3 to 5 years
PRICING	Cheaper than NAV facilities (dependent on rating of investors)	Usually more expensive than subscription facilities, although will usually be affected by the quality, level of concentration and nature of the underlying assets
SECURITY	Uncalled capital commitments – upward looking	Investment portfolio – downward looking
DUE DILIGENCE	Typically focused on fund documentation (ie subscription agreements, limited partnership agreements, side letters, and offering documents)	Focused on the underlying portfolio

ISSUES SPECIFIC TO FUND FINANCE TRANSACTIONS AND STRATEGIES ADOPTED TO ADDRESS THEM

The Guide sets out a non-exhaustive list of challenges that have been observed in the application of the SLLP to fund finance transactions. Ultimately, it is for the parties to the transaction to determine, following the requisite assessment of all the relevant factors, the transaction's suitability for an SLL. In the paragraphs that follow we will examine some of the challenges identified in the Guide, as well as strategies that the market has adopted to address the relevant concerns.

Borrowers in fund finance transactions, particularly subscription facilities, tend to be recently formed and therefore have limited historical data available for review and often lack a pre-existing sustainability strategy. It may be possible to draw comparisons with other funds that are associated with the borrower, but due care will need to be taken as to the appropriateness of this approach. While there is a certain need to compare apples to apples, comparisons with other funds are unlikely to be suitable where each fund has differing strategies.

Although at first glance funds with investment mandates relating exclusively to ESG strategies would appear ideal candidates for ESG-linked financings, they may, in actual fact, find it difficult to convince lenders that their KPIs and SPTs are sufficiently ambitious to go beyond the business-as-usual trajectory. In this instance, rather than structuring their facility as an SLL, they may find it more straightforward to meet the requirements of a green or social loan.

The relatively short tenor of most fund finance facilities will require borrowers to give serious consideration as to whether the additional hurdles required to put an SLL

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in place will offer sufficient benefits to make it worthwhile, especially when the majority of SLLs will only apply a pricing adjustment after the first year of a facility. This is intensified further in cases where there is a lack of historical data and the first year is needed to establish relevant benchmarks against which SPTs can be measured in the following years.

Setting quantifiable and strategically significant KPIs at the fund level can also be challenging because of the limited internal operations that such borrowers typically have; it is common for funds to have few employees and limited physical office space, if any. In this scenario it is common for the borrower's sustainability strategy to be implemented by its investment fund sponsor and, therefore, an SLL at the sponsor level may be preferable to multiple SLLs offered to the individual funds. Another common approach can be to formulate investment level KPIs, but this is not a straightforward process either, particularly where there is uncertainty or a lack of visibility over the fund's pipeline of investments. Additionally, in determining whether investment level KPIs and SPTs are sufficiently robust, lenders may need to review and diligence the process by which the fund chooses and manages its investments in a more in-depth manner than is customary in fund finance transactions. KPIs may also commonly be applied at the portfolio company level, with KPIs tailored on an investment-by-investment basis, which subsequently leads to a pricing adjustment on the subscription facility should KPIs be met across a specified percentage of the portfolio.

Given the importance of ensuring that the KPIs remain ambitious and relevant throughout the life of the facility, parties should include flexibility in the documentation to carry out a periodic review of the KPIs and include provisions which would bring the parties back to the table to renegotiate KPIs should they feel they are no longer appropriate. It may also be beneficial to include an ability to disapply any given KPI if agreement cannot be reached on the necessary amendments.

The reporting and verification requirements of the SLLP can also be more challenging on a fund finance SLL. Where the fund does not control the portfolio companies it can be difficult to ensure that the necessary data will be readily available to allow the fund to assess and report on performance against its SPTs. However, some funds will be regularly reporting on various metrics, including sustainability, to their investors and in such cases, funds may be able to readily harness the pre-existing reporting requirements, provided they meet the criteria of the SLLP. They would also need to take into account that, when negotiating and documenting the SLL, due consideration is given with regards to the timing of pre-existing reporting arrangements. In relation to external verification of performance against the SPTs, this process can be cost-prohibitive, particularly in instances where the fund has made numerous investments and has multiple portfolio companies using non-standardised metrics. In such a scenario, it is essential that the parties agree the nature and scope of verification when negotiating the SLL and consider whether the use of limited assurance is appropriate and acceptable to all parties.

A combination of a tough fundraising environment, higher interest rates, increases in pricing and concerns regarding leverage meant that 2023 was a challenging year in some segments of the fund finance space. Sustainability-linked fund financings, which had been on the rise in previous years, became a relatively rare occurrence as incorporating sustainability-linked provisions was perceived as adding an unnecessary layer of complexity and cost to transactions. However, market participants are optimistic for improved conditions this year and with new guidance assisting parties to navigate the particular challenges in applying the SLLP to fund finance transactions we predict that this will translate to an increase in SLL transactions in 2024. ■

Further Reading:

- Documenting SLLs: a comparison of the LMA/LSTA approach to sustainability provisions (2023) 7 JIBFL 447.
- 2021: the year of the sustainability-linked loan (2021) 10 JIBFL 675.
- Lexis+® UK: Banking & Finance: ESG integration in private debt.

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