

The Rise of ESG and Sustainable Fund Finance in Europe



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What is driving this change?

Challenges create opportunities and the environmental and social challenges we currently face are no exception. In this paper we consider the opportunities provided by sustainable finance, and more specifically impact financing and sustainability linked lending, in the context of fund financing. Before we delve into the detail on these relatively new types of financing we consider the key factors driving the move towards sustainable finance.

While initially asset managers were focused on clearly articulating the extent to which environmental, social and governance (“ESG”) considerations were taken into account in their investment decision making processes, there has been an increased focus, not only by asset managers but in entities across a wide range of industries, on: (i) how ESG factors are affecting their businesses more broadly; and (ii) the sustainability impacts of their businesses. It seems unsurprising then that this focus on ESG factors and sustainability has permeated into the world of financing with lenders providing more favourable terms to those that demonstrate positive steps, by way of achievement of measurable targets, being taken in their sustainability journeys or where financing is being used to fund projects which are considered sustainable.

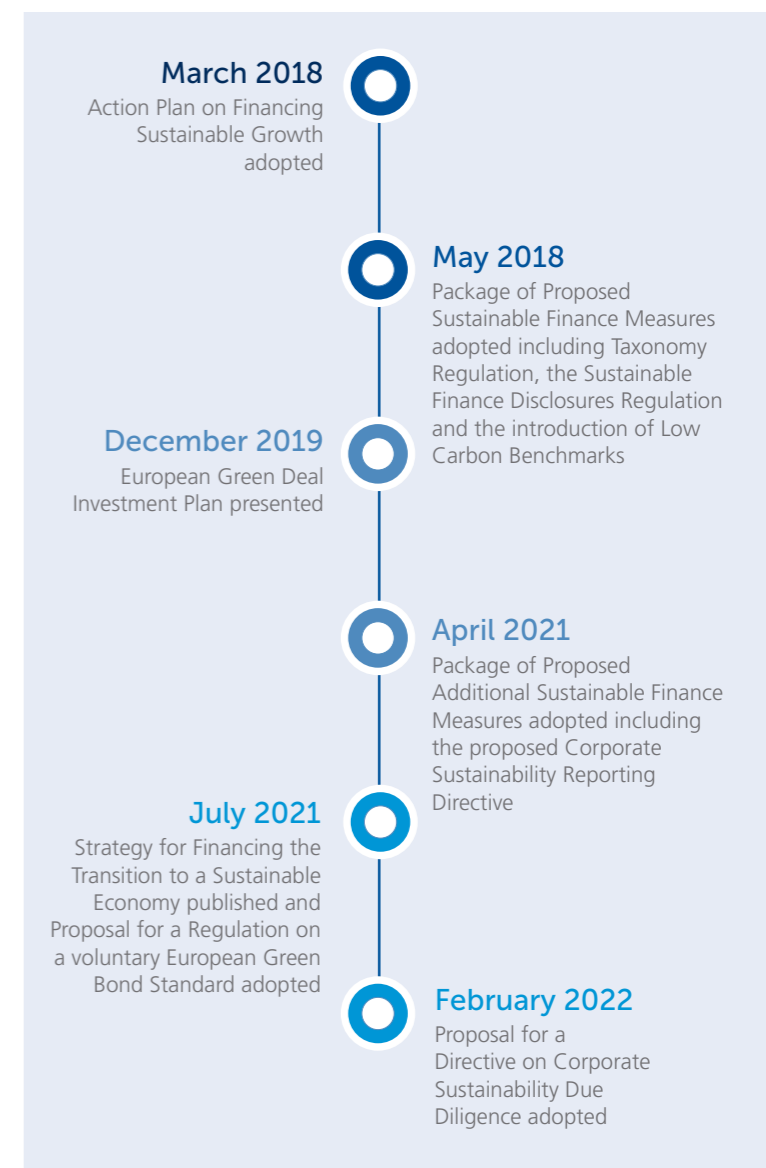
Alongside societal shifts generally, the impetus in Europe for the increased focus on ESG issues has been the introduction of legislation relating to sustainable finance and sustainability more generally. Investor demand is also playing a key role with asset managers that emphasise their ESG credentials under pressure to validate their claims through reporting and demonstrate how ESG considerations are taken into account as part of their decision making processes.

To understand how ESG fund financing has developed in the European Union (“EU”) to date, it is instructive to consider the key drivers of the broader shift to sustainable finance, in terms of both legislative requirements and manager, investor and underlying investment demand. This shift has resulted in the development of financing products with an ESG focus and this has filtered through to the fund financing sphere.

EU policy and regulatory focus

From an EU perspective, sustainable finance is seen as having a key role to play in ensuring that the EU meets its international commitments on climate and sustainability objectives including

those set out in the Paris Agreement relating to climate change and limiting global warming. The European Commission has made it clear that the utilisation of sustainable finance is critical to delivering the policy objectives of the European Green Deal, a strategy aiming to make Europe the first climate-neutral continent by 2050. The EU has been very active in implementing this strategy and formulating legislative proposals aimed at encouraging the use of private investment to drive the transition to a climate-neutral, climate-resilient, resource-efficient and fair economy.



Sustainable Finance Disclosures Regulation

The Sustainable Finance Disclosures Regulation² (“SFDR”) was published in the Official Journal of the EU on 9 December 2019 and principally sets out a number of disclosures that in scope entities are required to make on a phased basis commencing from 10 March 2021.

It applies to “financial market participants” including insurance companies, pension providers, credit institutions that provide portfolio management, investment firms, alternative investment fund managers (“AIFMs”) and UCITS management companies (“ManCos”) in respect of “financial products”, in the funds context these include UCITS and alternative investment funds. The regulation also applies to “financial advisers” defined as insurance intermediaries and insurance undertakings that provide advice relating to insurance based investment products and credit institutions, investment firms, AIFMs or UCITS ManCos providing investment advice.

Specific disclosures are required: (i) in the pre-contractual disclosures relating to the relevant financial product, for funds this is the prospectus or offering document provided to the investors; (ii) on the financial market participant’s website; and (iii) in the periodic reports for the relevant financial product. While SFDR sets out the high level disclosure requirements, the more granular details will be contained in level 2 regulations. These level 2 regulations are currently being finalised and pending publication there will be a period of uncertainty as to the exact information to be disclosed notwithstanding that the application date for these regulations has already been set as 1 January 2023.

SFDR also requires financial market participants to prepare and publish information relating to the integration of sustainability risks into their investment decision making process as well as the principal adverse impacts of their investment decisions on sustainability factors. Even those in scope entities that do not integrate sustainability risks or consider the adverse impacts of their investments are required to publicly disclose this information.

For financial products that promote environmental or social characteristics (known as Article 8 products); or have sustainable investment as their objective or have a reduction in carbon emissions as their objective (known as Article 9 products) further specific disclosures are required. In addition, the Taxonomy

Regulation introduces two further types of products where additional disclosure must be provided:

- (i) products that promote environmental characteristics (being a sub-set of Article 8 products under the SFDR, introduced by Article 6 of the Taxonomy Regulation); and
- (ii) products that invest in economic activities that contribute to an environmental objective (being a sub-set of Article 9 products under the SFDR, introduced by Article 5 of the Taxonomy Regulation).

Taxonomy Regulation

The Taxonomy Regulation³ was published in the Official Journal of the EU on 22 June 2020. A taxonomy is a classification system and this regulation sets out the high level criteria which need to be considered when determining how environmentally sustainable an investment is. It applies to (i) measures adopted by the European Union or its member states that set out requirements for financial market participants or issuers in respect of financial products or corporate bonds that are made available as environmentally sustainable; (ii) financial market participants (as defined in SFDR) that make available financial products (as defined in SFDR); and (iii) undertakings which are subject to the obligation to publish a non-financial statement or consolidated non-financial statement pursuant to the Accounting Directive⁴ as amended by the Non-Financial Reporting Directive (“NFRD”)⁵.

While the initial focus of the Taxonomy Regulation is on environmental objectives (specifically the six objectives detailed in the regulation – discussed further below), the intention is to broaden the classification system to cover social objectives in due course. A report was published earlier this year by the Platform on Sustainable Finance which considers the possibility of extending the EU taxonomy to social objectives. This would result in the classification of economic activities that significantly contribute to social objectives and represent a common code for investors, businesses and regulators regarding what is sustainable from a social perspective and what is not, similar to the taxonomy being developed in respect of environmental objectives in accordance with the provisions of the Taxonomy Regulation. One of the key next steps for the development of a social taxonomy is to conduct a study on the impacts of a social taxonomy considering different options for application and design.



The six environmental objectives set out in the regulation are: (i) climate change mitigation; (ii) climate change adaptation; (iii) the sustainable use and protection of water and marine resources; (iv) the transition to a circular economy; (v) pollution prevention and control; and (vi) the protection and restoration of biodiversity and ecosystems.

The criteria to be used to determine whether investments are in economic activities that are environmentally sustainable are set out in Article 3 of the Taxonomy Regulation. An economic activity will qualify as environmentally sustainable where that economic activity:

- (i) contributes substantially to one or more of the six environmental objectives set out above with the specifics detailed in Articles 10 to 16 of the Taxonomy Regulation;
- (ii) does not significantly harm any of the environmental objectives in accordance with Article 17 of the Taxonomy Regulation;
- (iii) is carried out in compliance with the minimum safeguards laid down in Article 18 of the Taxonomy Regulation; and
- (iv) complies with technical screening criteria developed by the Technical Expert Group (“TEG”) on Sustainable Finance.

Although the Taxonomy Regulation refers to six environmental objectives, the initial emphasis has been on those relating to climate given the urgency being placed on taking action to slow the rate of global warming. The specific technical screening criteria in respect of climate change mitigation and climate change adaptation were the first to apply from 1 January 2022 with the technical screening criteria relating to water and marine resources, the circular economy, pollution prevention and biodiversity to apply from 1 January 2023. With the initial legislative focus in the EU on climate change, it is unsurprising that climate finance, being funding to address climate change adaptation and mitigation, has been a priority for European lenders and borrowers alike although other types of green and sustainable financing are rapidly increasing in popularity.

Supplementary Initiatives

The Taxonomy Regulation and SFDR are two of the key building blocks of the EU’s sustainable finance framework as they establish a classification system and disclosure requirements which should provide guidance and information to investors when determining whether a particular product should be treated as sustainable. There are also a variety of other initiatives aimed at complementing these regulations. Such initiatives

are designed to: (i) assist with the development of sustainable products; and (ii) ensure that there is sufficient information available to assist investors in determining whether their sustainability preferences will align with the products available for investment including:

1. Amendments to the Benchmarks Regulation

Amendments⁶ to the Benchmarks Regulation were published in Official Journal of the EU on 9 December 2019 which introduced two new benchmark classifications, namely, EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks.

A benchmark can be labelled as an EU Climate Transition Benchmark where:

- (i) its underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a decarbonisation trajectory; and
- (ii) it is constructed in accordance with the minimum standards laid down in the delegated acts referenced in the Benchmarks Regulation.

A benchmark can be labelled as an EU Paris-aligned Benchmark where:

- (i) its underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio’s carbon emissions are aligned with objectives of the Paris Agreement;
- (ii) it is constructed in accordance with the minimum standards laid down in the delegated acts referenced in the Benchmarks Regulation; and
- (iii) the activities relating to its underlying assets do not significantly harm any other ESG objectives.

While both types of benchmarks focus on decarbonisation, the thresholds are higher for those benchmarks labelled as EU Paris-aligned Benchmarks. These benchmark classifications were created to: (i) allow a greater level of comparability while providing benchmark administrators with a degree of flexibility in designing the methodologies for such benchmarks; (ii) increase transparency on alignment of investment portfolios with specific climate ambitions; and (iii) prevent greenwashing (providing misleading information about environmental credentials and impacts of the environment).



In addition, these amendments to the Benchmarks Regulation require administrators of all benchmarks (with the exception of interest rate and foreign exchange benchmarks) to provide an explanation of how the key elements of the methodology being used for each benchmark or family of benchmarks reflects ESG factors and publish this information prior to 30 April 2020 together with updating the benchmark statement to include additional ESG disclosures.

2. Proposal for an EU Financial Products Ecolabel

The development of an EU ecolabel for financial products formed part of the European Commission's Sustainable Finance Action Plan with it anticipated that the introduction of such a label for retail products will encourage investments in sustainable economic activities as investors will be more readily able to identify sustainable products.

A draft decision under the Ecolabel Regulation⁷ was published in March 2021. It proposes that the EU ecolabel may be awarded to retail financial products with a reduced environmental impact during their entire life cycle. The EU ecolabel criteria for retail financial products will: (i) target the best retail financial products on the market, in terms of environmental performance; (ii) focus on the main environmental aspects associated with retail financial products and how they contribute to reorienting financial flows to achieve a low carbon, green and circular economy; (iii) aim to promote products that finance, through purchasing of shares, bonds and/or loans, activities that have limited impacts in terms of climate change mitigation and adaptation, and that are not environmentally and socially harmful activities; (iv) incentivise changes at the corporate level to improve the alignment of activities with the environmental objectives set out in the Taxonomy Regulation and/or grow shareholder value; and (v) support transparency for retail investors by ensuring that investors are provided with adequate information regarding the financial product.

While work on this proposal has stalled until work on the delegated acts under the Taxonomy Regulation have been finalised, it is clear that UCITS funds and those alternative investment funds targeted at retail investors will be among the products that will be capable of being awarded this ecolabel.



3. Proposal to establish an EU Green Bond Standard

As part of the announcement of the European green deal investment plan in January 2020 the European Commission published a proposal relating to the establishment of an EU green bond standard. In July 2021 the European Commission adopted a regulation on a voluntary European Green Bond Standard. This proposal will create a high-quality voluntary standard available to all issuers (private and sovereigns) to help with financing sustainable investments. The intention is that the European Green Bond Standard will set a “gold standard” for how companies and public authorities can use green bonds to raise funds on capital markets to finance ambitious investments, while meeting tough sustainability requirements and protecting investors from greenwashing.

It is proposed that all types of bonds, including covered bonds, asset-backed securities, and project bonds (i.e. bonds where the return of the bond is linked to the asset they are financing) will have the ability to be issued as European green bonds, provided they respect the requirements set out in the proposed legislation. However it should be noted that under the current proposal the standard will not be available to social bonds.

The International Capital Market Association has already developed a voluntary set of principles, the Green Bond Principles, which provide clarity on the characteristics of a green bond. In October 2021 the European Commission issued the first Next Generation EU green bond, raising €12 billion to be used exclusively for green and sustainable investments across the EU. This is part of the Next Generation EU green bond programme and followed the adoption of the Next Generation EU green bond framework in September last year. This framework is fully compliant with the Green Bond Principles.

4. Proposals relating to sustainability reporting and due diligence requirements

In April 2021, as part of its sustainable finance package the European Commission published a proposed new directive, the Corporate Sustainability Reporting Directive (“CSRD”) which aims to ensure that companies are reporting sustainability information in a consistent and comparable manner and that such information

meets the needs of investors and other financial market participants that require this information in order to satisfy requirements set out in SFDR. In addition, the proposal seeks to ensure consistency between reporting requirements under the Taxonomy Regulation and company sustainability reporting.

The NFRD lays down rules on disclosure of non-financial and diversity information in annual reports which currently only apply to certain large companies. The NFRD identifies four sustainability issues (environment, social and employee issues, human rights, and bribery and corruption) and with respect to those issues it requires companies to disclose information about their business model; policies (including implemented due diligence processes); outcomes; risks and risk management; and key performance indicators relevant to the business.

CSRD proposes a number of amendments to the NFRD that would see more companies being brought within the scope of its requirements, with the proposal being that large EU companies and all listed companies (except listed micro enterprises) will need to comply with these disclosure requirements in the future. In addition CSRD will introduce a requirement for the reporting of sustainability information to comply with mandatory EU sustainability reporting standards and an audit requirement for reported sustainability information.

The European Financial Reporting Advisory Group (“EFRAG”) has been assigned responsibility for the development of these standards and the intention is that these standards will be developed in tandem with the progression of the CSRD proposal through the European legislative process.

On 23 February 2022, the European Commission announced that it has adopted a proposal for a Directive on Corporate Sustainability Due Diligence. The aim of the proposed directive is to foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies’ operations and corporate governance. The new rules will also ensure that businesses address adverse impacts of their actions, including in their value chains inside and outside Europe.

This proposed Directive on Corporate Sustainability Due Diligence will complement NFRD and its proposed amendments (by way of the proposed CSRD) by adding a substantive corporate duty for in-scope companies to perform due diligence to identify, prevent, mitigate and account for external harm

resulting from adverse human rights and environmental impacts in the company's own operations, its subsidiaries and in the value chain.

In addition to the initiatives listed above it is also worth mentioning:

- (i) amendments being made to the legislation governing UCITS, AIFMs, insurers, investment firms and advisers, being MiFID II, UCITS, AIFMD, IDD and Solvency II frameworks. These amendments require relevant entities to take sustainability risks and factors into account and integrate these factors into the organisational, operational and risk management processes of such entities. In addition, the amendments will require those providing investment or insurance advice to obtain information about their clients' sustainability preferences and take these into account when providing advice; and
- (ii) the consultation launched by the European Commission in April 2022 on ESG ratings and sustainability factors in credit ratings. Issues such as transparency around data sourcing and methodologies and the timeliness, accuracy and reliability of the output from ESG ratings providers are all under consultation.

What is clear from the above outline is that there is a rapidly increasing amount of regulation being introduced in the EU with the ultimate collective aim being to shift capital towards more sustainable investments. Each of piece of legislation and proposal is designed to promote the transition to a climate-neutral, climate-resilient, resource-efficient and fair economy but legislation is only one piece of the puzzle with investor demand and public pressure more generally also playing an important role in the transition process.

Investor Appetite and Public Perception

As climate change and the impact of our actions on the world around us have come to the fore in recent years, first institutional and more recently retail investors have embraced the concept of sustainable investment. It is increasingly common for investors to adopt ESG charters. Some investors develop charters internally while others opt to align with an externally developed framework or set of principles. The UN supported Principles for Responsible Investment (the "UN PRI") sets out six principles reflecting the increasing relevance of environmental,

social and corporate governance issues to investment practices. These include incorporation of ESG issues into investment analysis and decision making and appropriate disclosure of ESG issues by entities into which such investors invest.

The UN has also developed the Sustainable Development Goals ("SDGs") which were adopted by all UN member states in 2015. Consideration of the 17 SDGs can help organisations identify which of the SDGs most resonate with the culture and values of the organisation and thus are a natural fit for implementation of its sustainability strategy. Organisations are increasingly considering the SDGs as a starting point for the development of their strategies around sustainability and the preparation of ESG policies, procedures and processes. In addition, making investments that align with one or more of the SDGs is becoming increasingly popular amongst investors.

Investors are also pushing asset managers to report on ESG issues and while some managers have reporting obligations under the NFRD, others are choosing to voluntarily report on ESG issues in advance of mandatory reporting being introduced and are relying on standards published by organisations such as the Global Reporting Initiative and the Sustainable Accounting Standards Board to provide focus to the reporting being prepared.

In recent years ESG issues, and in particular climate issues, have become a key concern for the public. In a world where lacklustre ESG credentials could result in the loss of business and affect employee recruitment, all organisations will be keen to promote their ESG activities as much as possible however it is crucial for the maintenance of public trust that such pronouncements can stand up to scrutiny as accusations of greenwashing could result in reputational damage.

"As climate change and the impact of our actions on the world around us have come to the fore in recent years, first institutional and more recently retail investors have embraced the concept of sustainable investment."

Level of Investment in ESG funds

Before turning to the developments in fund financing to take advantage of the opportunities presented by the increased focus on ESG factors, it is helpful to consider the extent of the growth in the number of funds being established with a specific ESG focus and the flows of capital into such funds to understand the scale of the potential opportunities available.

From an EU perspective, those funds promoting environmental or social characteristics or that have sustainable investment as their objective are categorised as either Article 8 SFDR funds or Article 9 SFDR funds, respectively, with investors seeking to make sustainable investments increasingly only willing to invest in funds that fall within either of these categories.

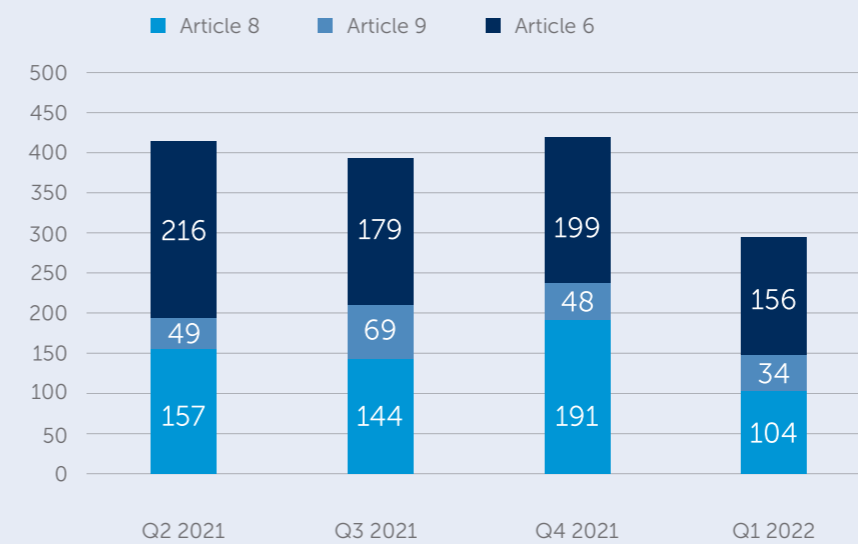
Irish Funds survey results published in May 2021 show that 17% of Irish domiciled funds were categorised as either Article 8 SFDR (12%) or Article 9 SFDR (5%) funds and these numbers are continuing to increase.

The current trend is for managers of funds with no specific ESG focus (known as Article 6 SFDR funds) to convert these funds into Article 8 funds in order to benefit from the increased investor interest in funds with a specific ESG focus. Interestingly, there is also a trend to convert Article 9 SFDR funds to Article 8 SFDR funds which likely stems from the obligations being introduced by the SFDR level 2 regulations. This is expected to be a temporary trend as greater clarity is provided and the issues with data availability in relation to underlying investments are resolved.

At management level, it is unsurprising that large asset managers with product offerings across a range of asset types which have the resources to build out their ESG capabilities, and those boutique managers specifically focused on thematic or

impact investing, are taking the lead in terms of ESG product offerings while middle tier managers (who may be more focussed on growth, have less expertise in the ESG space or less resources) are moving at a slower pace.

Quarterly number of fund launches

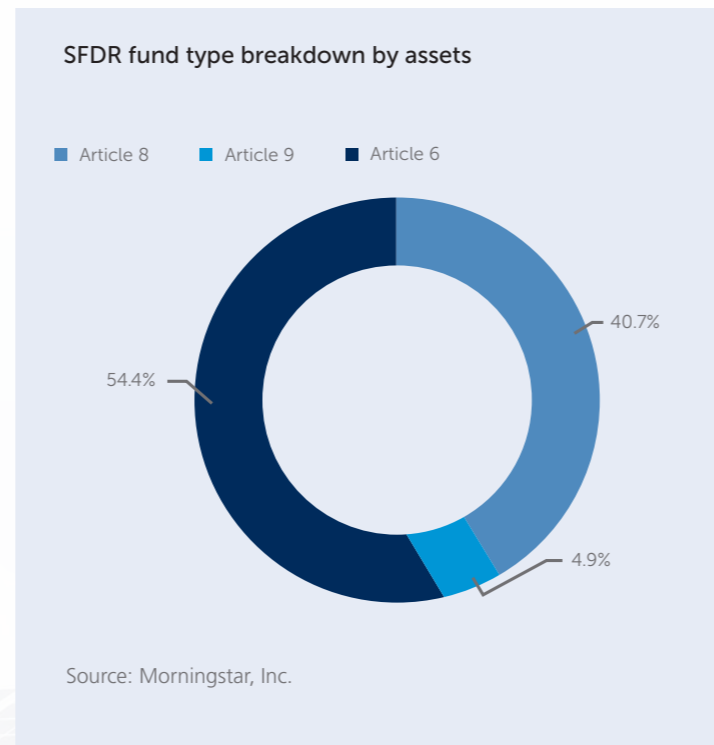


Source: Morningstar, Inc.

According to a market insights report⁸ published by the European Fund and Asset Management Association (“EFAMA”) in November 2021, net assets of Article 8 SFDR funds totalled €3.7 trillion, making up 22% of the European funds market at the end of the first quarter of 2021 with net assets of €340 billion, or about 2% of the European funds market, invested in Article 9 SFDR funds at the end of the first quarter of 2021. The Morningstar data shown above indicates that the percentages of EU funds categorised as Article 8 SFDR funds increased to 40.7% by the end of March 2022 while those categorised as Article 9 SFDR represented 4.9% of the funds market.

According to Morningstar by the end of the first quarter of 2022 assets held in Article 8 and Article 9 SFDR funds exceeded €4.1 trillion. This figure takes into account the flows out of funds categorised as Article 8 SFDR that occurred during the first quarter as a result of a number of factors including market volatility, geopolitical risks and inflationary pressures together with the types of assets typically invested in by such funds.

Funds categorised as Article 9 SFDR did not have a similar experience, instead the flows into such funds remained positive during this period.





Data Availability Issues

Issues with the availability of ESG data are a key challenge for those across the financial services industry and indeed more broadly. Although there are several data vendors that provide ESG data, there is a lack of coverage and comparability related to some ESG metrics and indicators. In September 2021, Irish Funds published a paper focused on principal adverse impact (“PAI”) reporting under SFDR⁹. Irish Funds conducted analysis of the mandatory PAI indicators available in the market from ESG data vendors. The initial findings from the paper revealed:

- in terms of coverage, no single vendor has >70% coverage across all the 14 mandatory indicators;
- there is wide variance in the data provided, particularly for climate data (divergences of >50% in the reported results are common);
- poor comparability between the reported PAI indicators from the various vendors as a result of the coverage and variance issues; and
- poor suitability of data (i.e. complete methodological alignment with PAI indicators as opposed to similar metrics that have been adapted for PAI purposes).

The analysis identified that financial market participants, as defined in SFDR, may consequently need to engage multiple vendors, which could disproportionately increase costs without necessarily improving data quality. The analysis focused on public markets and there are even bigger challenges for private markets given that the requisite data is not readily available. In February 2022, Irish Funds re-engaged with data vendors to determine whether there were any improvements in terms of the issues identified in the initial analysis. While challenges remain, the number of indicators for which data is available is continuing to increase. For private markets, asset managers that invest specifically in sustainable investments are more likely to receive ESG data reports from the underlying assets as sustainability is a key strategic objective for those investments. For other private assets, asset managers will likely have to engage with underlying investment to request ESG data.

Challenges that asset managers may face in seeking data on underlying investments include that: (i) ESG is not at the core of an investee company’s strategy and therefore they do not have the types of data being sought by asset managers; (ii) currently

in many jurisdictions investee companies are not subject to mandatory sustainability reporting although some companies choosing to report under a variety of different voluntary standards; (iii) data capture is very manual and there are risks relating to the accuracy of such data. With steps being taken to introduce mandatory sustainability reporting requirements those seeking to access capital should consider implementing an ESG reporting framework as asset managers and others within the scope of SFDR are already subject to reporting obligations on the sustainability of their Article 8 SFDR and Article 9 SFDR products. Such entities should be assessing which vendors can provide support in relation to these reporting obligations.

MUFG Solutions

MUFG public markets solution, ESG Transparency Report, focuses on ESG risk ratings for portfolios using data from ESG data vendors. In addition, the solution captures raw ESG metrics at the portfolio level which supports reporting for the SFDR. The private markets solutions, ESG IQ, has been developed to support ESG data capture for fund of funds, real estate, and private assets. The tool includes tailored ESG questionnaires and ESG metric data capture. MUFG’s team works with the clients in terms of their underlying assets to capture the data and then ESG IQ aggregates the ESG data to provide risk and analytical reporting.



Types of ESG Financing

Lenders are increasingly setting their own sustainability objectives and are keen to do their part to contribute to a more sustainable world and to take ESG considerations into account in their own businesses. The increased regulatory focus on ESG matters has created opportunities for lenders to offer new financing products that facilitate the flow of capital towards sustainable activities. These products are discussed in further detail below but typically include favourable terms where certain pre-determined ESG criteria are satisfied. This rapidly developing market is helping to further drive the ESG agenda by incentivising borrowers to pursue ESG goals.

The opportunities being created in the financing space as a result of the increased focus on ESG has led to a new sub-set of financing known as ESG Financing. This can broadly be split into two categories:

- Impact Financing (also known as “Use of Proceeds” financing); and
- Sustainability Linked Lending.

A key characteristic of ESG Financing is a partnership between the borrower and lender with a common goal of achieving measurable changes which ultimately positively impact the real economy, it often (but not always) allows for more favourable terms for the borrower where certain pre-determined ESG goals and conditions are satisfied. This mechanic is intended to provide the borrower with short term tangible rewards where it meets its ESG goals.

All aspects of ESG can be catered for but the initial focus has been on ‘E’ - funding to address environmental goals, and more particularly climate financing which seeks to address climate change mitigation and adaptation. Sustainable financing is a broader concept and extends to the ‘S’ and ‘G’ factors in ESG. Social considerations include human rights issues, inequality, inclusivity, labour relations and investment in communities, while good governance ensures that environmental and social considerations are considered as part of an organisation’s strategy.

There are no mandatory rules which apply when determining whether a particular goal or condition aligns with ESG principles and it is ultimately up to the finance parties to determine whether

the ESG goal selected withstands scrutiny and strikes the correct balance between what is achievable and motivational.

Some guidance is available however, the Loan Market Association (“LMA”), Loan Syndications and Trading Association (“LSTA”) and Asia Pacific Loan Market Association (“APLMA”) have jointly published green loan principles (“GLP”) and social loan principles (“SLP”) related to Impact Financing. In the Sustainability Linked Lending space they have also jointly published the Sustainability Linked Loan Principles (“SLLP”).

Impact Financing

Also known as ‘Use of Proceeds’ financing. The proceeds of such loans are used for specific ESG purpose(s) in line with specified eligibility criteria without any requirement to monitor individual goal achievement (i.e. no KPIs).

The GLP and SLP set out a non-exhaustive list of categories which would be considered as satisfying green or social objectives, including renewable energy, energy efficiency, pollution prevention and control, environmentally sustainable management of living natural resources and land use, terrestrial and aquatic biodiversity conservation, affordable basic infrastructure, access to essential services, affordable housing, employment generation, food security and sustainable food systems, socioeconomic advancement and empowerment.

In a fund financing context Impact Financing is most suited to managers of thematic or impact focused funds that specifically invest in sustainable projects, in the EU typically categorised as Article 9 SFDR funds and so will already have ESG principles entrenched in their investment decision making processes and risk management frameworks. It may also be appropriate in less mature markets or in fund of one situations where the borrower fund has a single investor driving change.

The application of proceeds towards a qualifying objective typically benefits from a favourable ESG pricing rate for the borrower. Failure to satisfy eligibility criteria does not usually trigger an event of default but can result in a margin increase or standard pricing.

Facilities may also have an option to apply all or a portion of proceeds towards non-ESG objectives and such loans will carry standard pricing.

Sustainability Linked Lending

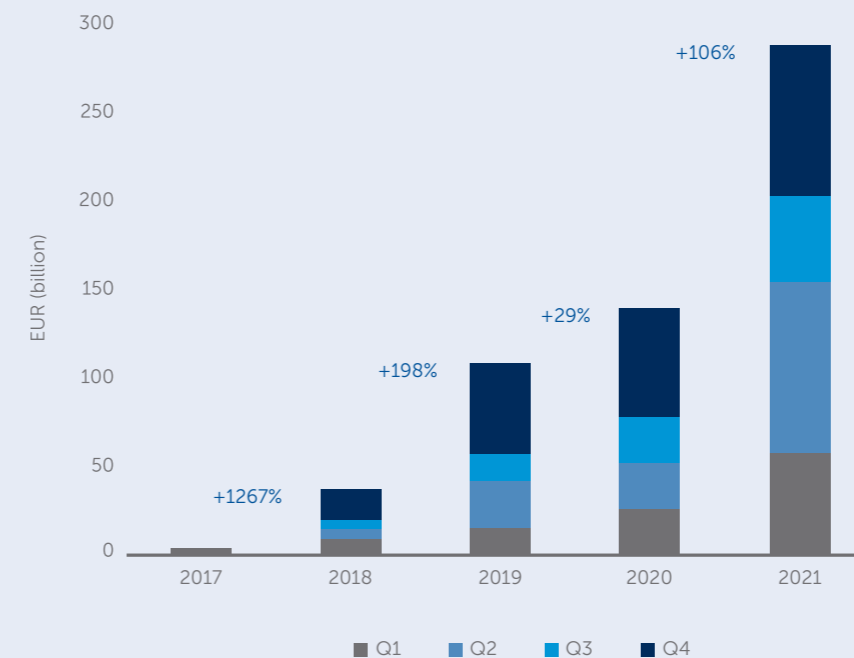
The SLLP refers to sustainability linked loans as any types of loan instruments and/or contingent facilities which incentivise the borrower's achievement of ambitious, predetermined sustainability performance targets ("SPTs"). As with all elements of ESG Financing, it is important that the principles of accountability, transparency and credibility are applied with selecting SPTs with right level of ambition also required to ensure that real progress is made when the SPTs are met.

SPTs are measured by predefined key performance indicators ("KPIs"), which may comprise or include bespoke criteria, external ratings and/or equivalent metrics, and which measure improvements in the borrower's sustainability profile. Where KPIs are met this will typically (but not always) unlock favourable terms for the borrower.

Sustainability Linked Lending can be distinguished from Impact Financing as the use of proceeds is not a determinant in its categorisation and, in most instances, sustainability linked loans will be used for general corporate purposes. Instead of determining specific use(s) of proceeds, sustainability linked loans provide more flexibility and reward improvement in the borrower's sustainability profile by aligning loan terms to the borrower's performance against the relevant predetermined SPTs. A performance based facility is more likely to be utilised for a fund that is not wholly ESG focussed as it is not necessarily a requirement that all loan proceeds be applied towards the attainment of ESG goals.

According to the Sustainable Finance Report published by Association for Financial Markets in Europe ("AFME")¹⁰, in the fourth quarter of 2021 Sustainability Linked Lending represented 80.9% of the total ESG linked market which itself increased 106% year on year in 2021. The adjacent chart shows the exponential growth in ESG linked loan issuances in the past five years and there are no signs of this growth slowing.

European sustainability linked and green linked loan issuance (2017 to 2021)



Source: Dealogic



Key Performance Indicators

There is currently no market standard for KPIs but any KPIs selected should be intrinsic to the borrower's business, clearly identifiable, quantifiable and preferably capable of benchmarking by reference to an external source. It is important that the KPIs are ambitious yet achievable so as to motivate the borrower to take additional steps to hit its targets and achieve meaningful change. It is not sufficient to set KPIs which the borrower would have achieved regardless of whether the financing was entered into.

KPIs can be set at both entity and product level and examples include specific carbon reduction targets, affordable housing unit construction and specific gender percentage targets for senior management roles. In keeping with the collaborative nature of the arrangement, borrowers and lenders work together to identify and set KPIs linked to specifically tailored SPTs. To date, the majority of borrowers have been focused on environmental impacts where progress can be clearly measured, for example a

A number of factors are relevant when selecting KPIs, these include:

- Term of loan – in our experience the tenure of Sustainability Linked Lending facilities frequently mirror subscription lines (i.e. 2/3 years with option for 1 year extension). Term is relevant to any conversation on KPIs as it can take 6 to 12 months before performance of a KPI can be verified so as to unlock any corresponding benefit. Equally, facilities with a longer tenor may need to include mechanisms to revisit KPIs (e.g. option to set KPIs periodically via side letters) in line with evolving ESG practices.
- Lifecycle of Fund – setting year on year targets for an early life fund may not be appropriate, as it is more likely to make exponential advances in KPIs. Conversely, year on year targets may be appropriate to drive change in a fund with years of ESG performance data points to reference.
- Number of KPIs – three to five KPIs are common. Depending on the SPT, it may be possible to accurately measure change using fewer high quality KPIs. The focus should be on measuring successful achievement of the particular SPT. It is important to strike a balance between administrative burden and verification of SPT(s) by reference to KPIs.
- Reporting Obligations – reliable reporting is the bedrock of any Sustainability Linked Lending facility. From a lender

perspective, reporting will ideally be performed quarterly but at least once per year. This is typically paired with delivery of an ESG compliance certificate and independent valuation reports annually. If the fund is not already set up to monitor and report on the chosen KPIs it may be more efficient from a cost / benefit perspective to outsource reporting to an external provider. Audit / dispute rights can also be negotiated to challenge any KPI results. While failure to meet KPIs does not usually result in a default (see further below), inaccurate / incomplete reporting may trigger a breach of any reporting covenants.

- External Benchmarks – finance parties may opt to align KPIs to external benchmarks e.g. referencing the reduction of greenhouse gas emission goals set out in the Paris Agreement, alignment with the UN PRI framework or incorporation of the principles of the UN Global Compact. There is also the option to avoid bespoke KPIs and use third party sustainability metrics which will feed into the pricing mechanics.
- Type of underlying investments – it may be more appropriate for funds with a stated ESG purpose to opt for Impact Financing and avoid the complications that come with SPT & KPI monitoring.





Incentives for hitting KPIs

Apart from contribution to the greater good, the most prevalent incentive for satisfaction of KPIs is a favourable pricing adjustment for the borrower. The adjustment varies but tends to fall between 2 and 25 basis points. Conversely, failure to meet KPIs can result in a margin increase (the market seems to have settled on 5 basis points) or exclusion of the ratchet.

Given that Sustainability Linked Lending is a tool used to drive positive ESG change, failure to meet KPIs does not typically trigger a default. This reflects the collaborative nature of the product and the shared goal of the parties to drive change in the ESG space by setting ambitious ESG goals. If failure to meet KPIs led to default it would naturally suppress ambitious goal-setting and so temper overall ESG progress.

KPI incentives can also be layered e.g. a primary KPI must be achieved before unlocking the pricing adjustment. Pricing can be further impacted by ancillary KPIs but if primary KPI is not satisfied ancillaries will not, of themselves, result in a pricing adjustment.

A talking point in the capital relief space is whether monies released by the pricing adjustment should be applied towards a stipulated ESG use or whether failure to meet KPIs should give rise to an obligation to make a charitable donation. We have not yet seen this mechanic in the fund financing space and it remains to be seen if this feature will gain traction in the market.

MUFG have invested heavily in this area and provide services with respect to both ESG financing and ESG asset servicing which allows for a tailored service offering to clients. As a lender with \$20 billion+ of subscription line finance, the ability of the team to integrate ESG IQ with ESG financing is proving to be a key differentiator in the market. This is because the whole process from education of underlying investments, calibrating KPIs in a tailored way which works for the fund, collating information and reports at all relevant levels of the fund and investor structure and then lending to that fund with the ESG benefits it brings, can all be done under one roof and is a compelling offering.





Looking Ahead

The rapidly evolving legal and regulatory landscape in terms of sustainable finance and sustainability more broadly creates both challenges and opportunities for those seeking to reorient capital to sustainable investments.

One view is that many of these challenges will be short lived as legal and regulatory requirements are finalised allowing market participants to confidently implement their chosen ESG strategy, resulting in further expansion of the ESG agenda. An alternative view is that once the various ESG regimes are finally implemented, there will be a period of relative inactivity while the market realigns itself with new requirements e.g. data capture systems may need to be updated in order to meet reporting requirements.

What is clear is that the recent focus on ESG is only likely to intensify and the further codification of ESG requirements will present huge potential for innovation in sustainable finance product offerings e.g. an interesting and progressive development we have seen is for a manager to link its carry to ESG KPIs.

We expect ESG elements to become an increasingly common feature of fund financings with a more standardised approach developing as sustainable finance becomes more widespread.

Footnotes

1. Regulation (EU) 2016/1011.
2. Regulation (EU) 2019/2088.
3. Regulation (EU) 2020/852.
4. Directive 2013/34/EU.
5. Directive 2014/95/EU.
6. Regulation (EU) 2019/2089.
7. Regulation (EC) No. 66/2010.
8. [EFAMA: The European ESG Market At End Q1 2021 - Introducing the SFDR](#)
9. [Irish Funds: Principal Adverse Impacts Reporting](#)
10. [AFME: ESG Finance Report](#)

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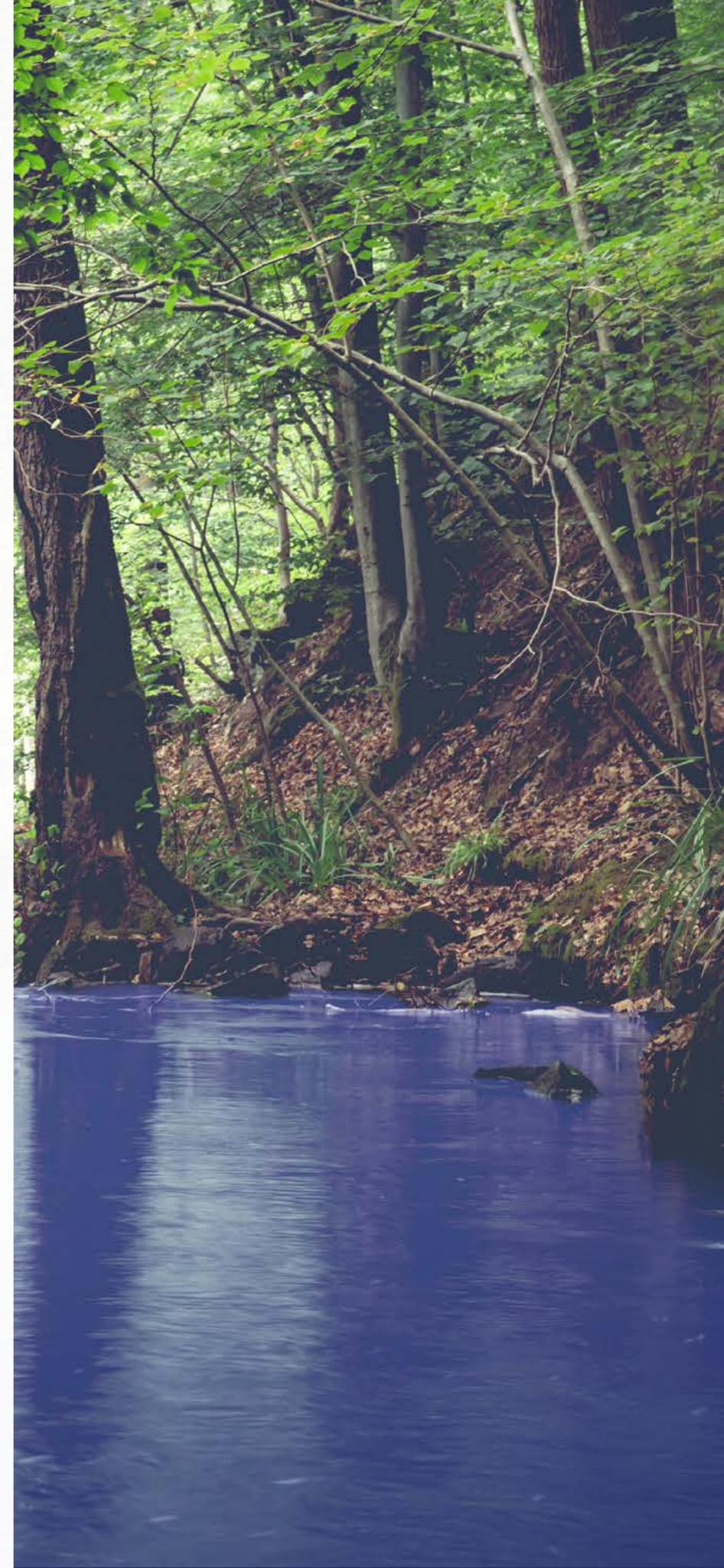
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