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THE ROLE OF ESG FINANCING IN THE BANKING MARKET

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GREEN
#2 in a series of briefs on sustainable financing

Towards sustainable Bank Financing

The banking sector has dealt with many transitions over the years. EU regulation on sustainable finance is pushing the sector into rethinking its core business – lending money to businesses.

In general, the term ESG finance covers all sustainable, including 'green' and 'social', finance. Among the most recognized types of ESG loans today you will find *green loans* and *sustainability-linked loans*.

Particularly booming in 2019 were the sustainability-linked loans as one of the key products, and new data tells us that this development continued into 2020. Such loans differ from green loans. Sustainability-linked loans can be applied for any sustainable purposes (green or not) - however, an in-built pricing mechanism means that the loan is cheaper if the borrower achieves certain sustainability performance targets.

This briefing note will take a closer look on what green- and sustainability-linked loans are and how banking institutions are applying these loans in their sustainable loan portfolios.

Sustainability-linked Loans and Green Loans

Green Loans

Green loans are used to fund green projects. They are based on the Green Loan Principles[1] and aim to facilitate and support environmentally sustainable economic activities. Basically, they are structured as conventional loans save that the proceeds from the green loan are allocated to finance eligible projects which are listed in a non-exhaustive list of 10 indicative green categories with CO2-reductions as ultimate purpose. The proceeds must be tracked, for instance by crediting them to a dedicated account and the borrower is required to report to the lender how the proceeds are utilized and what the impact is.

Sustainability-Linked Loans

Sustainability-linked loans set out predetermined sustainability performance targets, which entails that the loan margin is reduced if the borrower fulfills the specific targets. Therefore, the sustainability-linked loans are connected to the borrower's overall sustainability profile. Such loans can be CAPEX facilities, revolving credit facilities, acquisition facilities and can be used for general corporate purposes. The goal is that the borrower gets incentivized to

[1] The Green Loan Principles and Sustainability-Linked Loan Principles have been prepared by the Loan Market Association and the Loan Syndications & Trading Association, among others.

improve performance over time as the performance against the predetermined sustainability objects affects the interest rate. The objectives are defined in the Sustainability-Linked Loan Principles and includes reduced CO2-emissions, reduced water consumption and the amount of renewable energy generated by the borrower etc.

The Green Loan and Sustainability-linked Loan Market

The market for green loans and sustainability-linked loans is undergoing a fast-paced upwards trend primarily driven by banking institutions targeting internal ESG goals. The green loan and sustainability-linked loan markets have seen a serious combined increase from USD 69 billion in 2018 to USD 166 billion in 2019. Interestingly, out of the USD 69 billion in 2018, USD 47 billion was sustainability-linked loans. In 2019, sustainability-linked loans amounted to approximately USD 135 billion out of USD 166 billion syndicated green loans and sustainability-linked loans collectively. According to Refinitiv, IFR ESG Financing Data Briefing, 19 June 2020, sustainability-linked loans already accounted for a staggering USD 52.5 billion in 2020 year to date until 19 June 2020.

Examples of the borrowers of sustainability-linked loans are the major Danish transportation company A.P. Moller - Maersk and the UK based energy company National Grid. Maersk secured a USD 5 billion sustainability-linked revolving credit facility, the margin of which is linked to its CO2 performance. National Grid secured a green loan worth USD 743 million to finance the Viking Link interconnector project, which is a joint project with the Danish system operator Energinet.

Many major banks operating in Denmark provide sustainable loans, primarily within environmental sustainability. Quite a few of these banks push to expand their sustainable loan portfolio and now provide e.g. sustainable auto loans with lower interest rates and fee discounts (compared to conventional loans) and sustainable real property loans backed with security in the real property.

The financing institutions have varying risk preparedness, but traditional banks are generally very risk adverse, so by enabling the banks to better assess the ESG risk and link this to the credit risk associated with the sustainable loan, you will see a further spike in the banks' and other financing institutions' readiness to offer borrowers sustainable loans, which will benefit the primary market.

For borrowers demanding sustainable loans exceeding any standalone lender's appetite, syndicated sustainable loans will be easier (and more cost efficient) to close if the financing institutions participating have some common understanding of what a sustainable activity is and how the impact of such should be measured. By having a standard, it will be easier for lenders to sell commitments on the secondary market, which defuse many of the reservations a primary market lender may have before committing to a sustainable loan.

Advantages in Green Loans and Sustainability-linked Loans

Sustainable solutions have become profitable to big scale lenders and borrowers. The first quarter of 2020 revealed distinct excess returns in green investments in the highest rated ESG-related companies according to French based asset manager AXA Investment Managers (managing around EUR 800 billion).

Especially sustainability-linked loans are flexible and can provide good reputation for both lender and borrower. The borrower is not required to apply the proceeds towards green or social activities, but there is a clear incentive to achieve certain sustainable or ESG related targets triggering the in-built pricing mechanism. This will make the loan cheaper to the borrower and also more attractive than restrictive green loans.

Further, corporate managements are focusing increasingly on implementing a cli-mate agenda to accommodate public and shareholder opinion and benefit from the positive messaging which is associated with responsible corporate behaviour. The same applies to international banks, as these are moving away from fossil in-vestments and chase renewable lending targets.

ESG Mechanics in the Credit Agreements

Generally – Information undertakings: How and when?

In general, information undertakings will be a focus point in all sustainability credit agreements, and in particular reporting on ESG metrics, e.g. CO2-reductions. For green loans, the borrower should report on the green projects to which the proceeds are allocated and the impact of the financing. The key to an efficient reporting scheme is transparency in the link between the use of proceeds and the sustainable impact as such an objective and generic approach is recommended. The metrics need to be meaningful to the type of project being financed. The lender and the borrower should also address whether such reported metrics should be verified by independent third parties. If the metrics can be quantified, it should be considered whether such should be included in the compliance certificate issued quarterly. It is expected that the lender requires the borrower to make certain representations on the borrower's ESG policy.

Green Loans: Use of Proceeds

Green loans adhering to the Green Loan Principles must be allocated to green pro-jects, i.e. the projects must comply with certain technical criteria of both quantitative and qualitative character. As a result, a thorough description of the purpose clause in the credit agreement is expected. Lenders may want to divide their commitment into tranches, which will be made available when the borrower meets certain metrics as the green project progresses. If the loan is divided into tranches, we advise that the metrics are easily measurable, preferably quantifiable, to allow for predictability on when the commitments are available to the borrower. This will be in the interest of all parties.

To deter green washing – when the borrower has used proceeds earmarked to sustainable activities for non-sustainable purposes – a maintenance-based covenant will ensure that the green loan is only used for environmentally sustainable projects and activities. As such, an event of default could be triggered if the green loans are not used for green projects. An event of default will not be triggered if the impact of the green project turns out to be less than anticipated. However – and similar to conventional credit agreements – the event of default should only occur if the borrower is not capable of remedying the breach within a set timeframe.

Sustainability-Linked Loans: Setting Sustainability Performance Targets

The lender will incentivize the borrower to meet performance targets by granting a discount on the loan margin – typically a relative discount in the range of 3-7% – or the margin could be increased if the borrower fails to meet the targets. In sizable facilities agreements, it will be expected that the discount will be linked to a grid aiming that the discount will increase depending on more than one sustainability performance target. We recommend that the calculation model is included in the credit agreement, or at least the principles for the calculation. The relevant period for the sustainability performance targets could either be the lifetime of the loan (which mostly will be relevant for term loans), or a certain shorter period which could follow the financial reporting under the credit agreement, e.g. every year included in the compliance certificate. Too many ESG reporting dates per year is not advisable as it may impose unnecessary costs for the borrower, especially if the reporting must be certified by a third party.

The Future

We are already seeing various banks offering sustainable loans on attractive terms to borrowers and the market is gaining traction rapidly. As the sustainable financing market grows, funds will flow towards this area of business. Lenders will get more data points on increasingly reliable green and sustainable-linked loans and risks of borrowers across macro-sectors, which will further boost the sustainable loan market. The standards will be sharpened and market practice on which metrics to evaluate, how to efficiently report and how to set sustainability performance targets will stabilize.

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If you have any questions or require further information regarding any of the above, please do not hesitate to contact us:

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