GREEN AND ESG LOANS – EMERGING TRENDS

BASED ON THE MOMENTUM OF THE GREEN BOND MARKET OVER THE PAST DECADE AND THE SUBSTANTIALLY INCREASED SUSTAINABILITY FOCUS OF STAKEHOLDERS, AN INCREASING NUMBER OF BORROWERS AND LENDERS ARE EXPECTED TO ENTER THE EMERGING GREEN LOAN MARKET. BY CYNTHIA URDA KASSIS, PARTNER, JASON PRATT, COUNSEL, AND MEHRAN MASSIH, COUNSEL, SHEARMAN & STERLING.

Lenders are working feverishly both to meet this demand and to adopt internal standards to manage the benefits and risks of these relatively new loan products.

These efforts are seconded by financial industry groups that have recently issued guidance documents – the Green Loan Principles (GLPs) and the Sustainability Linked Loan Principles (SLLPs) – designed to harmonise what is, for the most part, still a wholly voluntary, ad hoc and industry-driven market.

Based on the newness of the market, there has yet to emerge one set of commonly-accepted market loan provisions. Lenders and borrowers should monitor developments in how the benefits and risks of these new products are managed in loan documentation, as they are bound to shift dynamically over the next few years.

The overarching concepts that are expected to continue to dominate management of these legal issues are identifying qualifying projects and assets, arranging independent review, and tracking and reporting over the course of the loan.

Definitions

At the moment, two types of sustainable loan instruments have emerged in the market: green loans and environmental, social and governance-linked loans.

Green loans are any type of loan instrument made available exclusively to finance or refinance green projects, such as those tied to increased energy efficiency, avoided carbon emissions, or reduced water consumption.

Environmental, social and governance-linked loans, also referred to as ESG loans or sustainability-linked loans, are any type of loan instrument and/or contingent facility, such as a bonding line, guarantee line, or letter of credit, that incentivises the borrower to meet pre-determined sustainability targets (PSTs).

PSTs can relate to, among other things, an increase in energy efficiency, the promotion of biodiversity, or improvements in working or social conditions.

Unlike with a green loan, proceeds from an ESG loan do not need to be allocated to a green project; in most cases proceeds from ESG loans are allowed to be used for general corporate purposes. With an ESG loan, the loan terms for the borrower, such as through margin determinations over the life of the loan, may become more favourable if the borrower meets its PSTs or less favourable if it does not meet them.

Benefits and risks

Green and ESG loans can help lenders and borrowers meet their own targets and comply with industry initiatives, such as the voluntary financial disclosures developed by the Financial Stability Board's Task Force on Climate-related Financial Disclosures, or TCFD.

Lenders are also monitoring what are still emerging regulatory requirements, such as those arising from implementation of the 2016 Paris Accord.

For borrowers, they are a tool for proactively adapting to more stringent regulatory regimes and mitigating the physical risks associated with global warming, such as increased fires, flooding, droughts or dam collapses, and other stresses on infrastructure caused by intense storms.

Participation in the green and ESG loan markets provides a talking point for banks and companies wishing to burnish their reputation for green and socially-responsible business practices.

In addition, green and ESG instruments could potentially afford borrowers (1) more favourable capital treatment – ie better rates, (2) an easier path through a lender's credit approval process, and (3) access to capital sources unavailable to non-green, non-ESG borrowers, for example from dedicated green and ESG capital pools.

Recent and growing shareholder activism, such as by pension funds opposed to new lending to fossil fuel producers, has helped to bolster the green loan market in this way. In jurisdictions with applicable regulations, participation in the green or ESG loan market may also provide tax benefits.

Greenwashing, where lenders or borrowers promote a loan as green-linked when the projects and assets underlying it could have dubious green credentials, is a fundamental risk of participating in the green loan market.

Any reputational or other benefits that accrue to green loan participants will evaporate if the instrument is deemed or perceived as not promoting sustainability.

Consequently, governments and industry members such as Barclays, Credit Agricole, HSBC, ING, Macquarie and Societe Generale, continue to refine their green vetting and performance standards.

Borrowers may also perceive green and ESG loans as imposing greater administrative burdens – for example, developing internal controls and the relevant sustainability expertise, and being subject to increased loan reporting or public disclosure requirements.

These burdens may be alleviated over time as the requirements become more standardised and expertise becomes more readily available in the market. Moreover, borrowers that have established internal controls and procedures to comply with green project finance considerations, most notably under the Equator Principles, will have a solid grounding to meet requirements in the green or ESG loan context.

Loan selection and documentation

Some common selection and documentation issues and trends are emerging in the green and ESG loan markets.

- *Green loans* – For green loans, a lender typically requires that a borrower submit a satisfactory action plan that sets out precisely how the loan proceeds will be spent.

A lender's internal sustainability auditors, or its outside consultants, commonly referred to as a second-party opinion provider, will analyse the proposed green project, as well as the borrower's capacity to ensure that the proceeds of the loan are spent on the green project and its ability to effectively manage any risks posed by the project. This review results in the lender or second-party opinion provider issuing an evaluation report.

Should the lender choose to proceed with the loan, the loan agreement will require that the borrower monitor the progress of the green project, and meet and maintain any project-specific milestones – eg, in the context of green buildings, achieving the US Green Building Council's Leadership in Energy and Environmental Design, or LEED, certification.

The agreement will also require that the borrower report on the progress of the green project on its website and/or in reports submitted to the lender. Some industry guidance documents call for annual reporting, although a lender may require more frequent reporting.

In connection with these reporting obligations, a lender may also require a borrower's performance and reports to be verified or certified by independent third parties and for the borrower to provide access to personnel, documents and perhaps projects for this purpose. Depending on a lender's familiarity with a borrower and confidence in its internal oversite processes, a borrower's self-certification procedure could suffice.

The agreement may require that funds be segregated in a dedicated account, a concept familiar to project finance borrowers. This may not be required if the borrower operates exclusively in green industries or the lender is satisfied that a borrower has effective internal fund allocation controls and procedures.

The documentation is likely to include some negative consequences for the borrower in the event that it fails to meet its green obligations – for example, by spending the funds on a project other than the agreed project or failing to obtain a relevant certification. The documentation may require a borrower to segregate funds in a dedicated account to remedy the relevant breach.

A mandatory prepayment is a more aggressive remedy; if such a remedy were agreed to in principle, the borrower should consider whether a cure period is appropriate. Penalty clauses, however, are not a favoured provision as they could have the perverse result of the lender reaping benefits from the borrower's green failures.

- *ESG loans* – For ESG loans, the first step is for the lender and borrower to agree on the PSTs – what metrics are relevant and how they will be judged. The most central loan provision is a reduction in margin if the borrower meets the PSTs.

If a borrower fails to meet the PSTs, and to eliminate the outcome of a lender enjoying a higher margin based on a borrower's ESG failures, a payment could be required to an account with funds only being available for expenses that improve the borrower's sustainability profile and perhaps that are green-lighted by the lender. Similar to green loans, ESG loans typically require meeting milestones, regular reporting, and third-party verification or certification of results.

Non-green industries

Although green loans must be used to finance green projects, and ESG loans must be used to incentivise the meeting of PSTs, neither is limited to green industries. Both can be used in non-green industries to finance green projects and to promote ESG goals. Having said this, investors have recently given a cool reception to green bonds issued by companies that form part of larger corporate groups engaged in carbon-intensive industries.

For heavy, carbon-intensive industry sectors, the challenge will be persuading the market – and regulators as a regulatory framework develops – that the relevant project or asset, taking into account the activities of the corporate group as a whole, are sufficiently green to qualify for these loans. Some heavy industry sectors, such as metals and mining, are well positioned in this regard.

As described in works such as the World Bank's "The Growing Role of Minerals and Metals for a Low-Carbon Future", a low-carbon future means sky-rocketing demand for strategic metals, such as lithium, graphite and nickel, which are key to developing low-carbon technologies such as solar panels, wind turbines, and batteries for electric vehicles, and those necessary for the continued integration of renewable energy into electrical grids. They also have possible energy and water use efficiency gains, and an ability to modify their engagement with local communities to improve the relationship.

It is therefore not surprising that metals and mining participation in the broader green finance market is growing. In July 2019, steelmaker POSCO became the world's first company in the steel sector to issue ESG bonds by raising US$500m to expand its investments in electric vehicle battery metals and renewable energy projects. On May 1 2019, the World Bank, partnering with the German government, Rio Tinto, and Anglo American, launched the Climate Smart Mining Facility, the first fund dedicated to making mining for minerals climate-friendly and sustainable.

In 2018, Natixis announced that it had developed its own Green Weighting Factor methodology for financing deals – factors that are being tested on four pilot sectors that include automotive, real estate, electricity and mining.

In October 2019, Rusal, a company with a large mining footprint, announced the signing of an ESG-linked pre-export finance facility in excess of US$1bn with PSTs relating to improvements in environmental impact and sustainability practices.

Previously, in April 2018, Polymetal International, another company with significant mining operations, converted a US$80m credit facility into an ESG-linked facility under which the PSTs were measured by a leading provider of ESG research and ratings.

We expect the green loan market will continue to hone eligibility criteria for metals and mining, as well as other industries that have a prominent role to play in a carbon-neutral future, such as demonstration of a transition to a lower carbon business model; identification of key mitigation and adaptation issues; and development of sustainability-focused governance frameworks, including senior management capabilities and incentives.

We also expect, however, that some industries will struggle to justify to the market and, as regulatory regimes are implemented in the future, regulators, that they have a role to play in the green loan market. Coal, and to a lesser extent oil and gas, may well be in such a position, despite room for efficiency gains, carbon capture, and improved methane leak control.

Voluntary guidance

Although the sustainability finance market is at the moment largely unregulated, there are guidance documents that are widely consulted by lenders and borrowers in connection with green or ESG loans and that are emerging as de facto market standards.

The two highest profile guidance documents, issued by the Loan Syndication & Trading Association, Loan Market Association, and Asia Pacific Loan Market Association, are the GLPs, published in March 2018, and the SLLPs, published in March 2019.

The GLPs and SLLPs have much in common. Both set out four core components, all of which must be satisfied for a loan to be deemed green-linked or ESG-linked.

Solar panel sunset. concept clean energy, electric alternative, power in nature © Dreamstime.com

For green loans, (1) the proceeds should be used for green projects that address green concerns, eg climate change, natural resources depletion, loss of biodiversity, and air, water, and soil pollution, the projects should be described in the loan documents and marketing materials, and the borrower should assess, quantify, measure and report the green benefits of the project; (2) the borrower should communicate to the lender its environmental objectives, and how its project fits within eligible categories of green projects, (3) the proceeds should be credited to a dedicated account, and (4) relevant information, including qualitative performance indicators and quantitative performance measures, should be reported to lenders.

For ESG loans, (1) the borrower should describe to the lender its sustainability objectives and strategies and how they align with PSTs, and should disclose any standards or certification to which it seeks to conform, (2) the borrower and the lender should negotiate the PSTs, (3) the borrower should make information regarding its sustainability targets readily available, provide such information to institutions participating in the loan at least once a year, and perhaps share the information publicly, such as in its annual reports, and (4) the borrower should seek an external review of its performance against the PSTs, especially if the information is not publicly disclosed or if there is no assurance statement made by the borrower to the lender.

An issue the drafters of the GLPs and SLLPs wrestled with is the appropriateness of third-party review of the green projects and PSTs, and third-party verification that the borrower is achieving its green and ESG goals. The GLPs suggest third-party review when appropriate, indicating that third-party experts could simply be consulted or, more robustly, could be retained to verify, certify or rate the green loan or green loan framework. The GLPs also, however, note the relationship-driven nature of the loan market and suggest that self-certification by a borrower may be sufficient.

Similarly, the SLLPs indicate that borrowers could seek a third-party opinion regarding the appropriateness of its PSTs and verification, at least annually, of whether it is meeting the PSTs, and that any such external reviewer should be agreed to by the lenders. The SLLPs also contemplate circumstances where the borrower has the internal expertise to evaluate the PSTs and its performance, and communicate this expertise to the lenders.

Emerging regulatory regimes

Most jurisdictions, including notably the United States, have no green or ESG loan regulations, and in these jurisdictions lenders and borrowers base their participation in the green and ESG loan markets on voluntary guidance such as the GLPs and the SLLPs. Other jurisdictions, such as India and China, have implemented regulations to govern the green and ESG loan markets.

The European Union is a jurisdiction where voluntary, market-driven practices inform lenders' and borrowers' participation in the green loan and ESG loan markets, but where a regulatory regime for sustainable finance has been proposed.

In March 2018, the European Commission published an action plan for integrating sustainability considerations into its financial policy, which culminated in May 2018 in proposed regulations to establish, among others things, a framework to facilitate sustainable investment and disclosure obligations for how institutional investors and asset managers integrate ESG factors into their risk management processes.

The timing of the EU's various proposals remains uncertain and different pieces are expected to move at different paces. One significant milestone that has been reached is the June 2019 publication by the Commission's Technical Expert Group on Sustainable Finance of technical screening criteria for 67 activities that qualify as climate change-mitigative across the sectors of agriculture, forestry, manufacturing, energy, transportation, water and waste, information and communication technologies, and buildings.

The EU taxonomy currently excludes activities in the coal mining sector as eligible for sustainable finance. This is relevant as the EU taxonomy is likely to emerge as a de facto standard on qualifying activities in what remains a scattering of more ad hoc standards. Natixis, for example, plans to eventually include the EU taxonomy in own Green Weighting Factor methodology.

Disagreements among EU member states also have emerged about classification under the taxonomy of gas and nuclear projects. Compromise amendments were made in December 2019 to the "do no significant harm" principle, which is the condition embodied in the taxonomy that activities that contribute to one environmental objective not significantly harm other sustainability goals. The EU Commission and EU Parliament reached a political agreement on the taxonomy's content late in the year.

In December, the European Commission also presented the European Green Deal, a growth strategy aiming to make Europe the first climate-neutral continent by 2050. As part of this Green Deal, the Commission presented on a European Green Deal Investment Plan on January 14, which is intended to mobilise at least €1trn of sustainable investments over the next decade.

Conclusion

The combination of the greening efforts of many industries, and the expansion of green and ESG-linked loan products and sources, have resulted in green and ESG-linked financing becoming a very relevant source of funding for many industry sectors. As this article indicates, the green and ESG-linked finance market is very much in a state of evolution. That said, there are clearly a variety of potential benefits to tapping this new source of funding. ■