# Sustainable Finance – The Rise of Green and Sustainability Linked Loans

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Berndt Pettersson, Advokatfirman Delphi

# Sustainable Finance - Agenda

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3. Market Activity
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# Sustainable Finance - Background

- Green or sustainable financing is by no means a new invention. Green bonds were the first form of green financing, created to fund projects with positive environmental or climate benefits, and the first green bond was issued already in 2007.
- Following rapid growth in the market, the International Capital Market Association (ICMA) published the first iteration of its Green Bond Principles (GBP) in January 2014.
- In comparison to the green bond market, the green loan market is relatively new and the market for sustainability linked loans even newer.
- A significant era for the green loan market started with the launch of the Green Loan Principles* (**GLP**s) in March 2018, followed by the launch of the Sustainability Linked Loan Principles* (**SLLP**s) a year later (in March 2019).

**Launched by the Loan Market Association (LMA), the Asia-Pacific Loan Market Association (APLMA) and the Loan Syndications and Trading Association (LSTA)*

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# Sustainable Finance - Background

- We have probably all heard of climate change and that climate change is one of the biggest challenges of our times, and that the situation is urgent. The signing of the Paris Climate Agreement and the adaptation of the UN 2030 agenda and sustainable development goals in 2015 marked the beginning of a new era in the context of fighting climate change and a shift in global attitudes towards climate change and sustainable development.
- In a European context, the European Union has taken the lead of this and in 2018, the EC adopted (and started implementing) its Action Plan on Sustainable Finance, with the objectives of (i) reorienting capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth, (ii) managing financial risks stemming from climate change, environmental degradation and social issues, and (iii) fostering transparency and long-termism in financial and economic activity.*

**Note also the European Green Deal, presented by the EC in December 2019, under which the EU has committed to becoming the first climate-neutral bloc in the world by 2050.*

# Sustainable Finance – Green Loans vs. Sustainability Linked Loans

- According to the GLPs, "**Green Loans**" are any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible Green Projects.
- The GLP set out a clear framework based around the following four core components:
  - Use of Proceeds (*the key component and characteristics for a Green Loan*)
  - Process for Project Evaluation and Selection (*should be clearly communicated to lenders*)
  - Management of Proceeds (*dedicated account or otherwise appropriately tracked*)
  - Reporting (up-to-date information on use of proceeds; list of Green Projects etc.)
- Green Loans do not (as opposed to Sustainability Linked Loans) typically, or have not at least traditionally, provide any financial incentives for the borrower, such as a lower margin. However, in certain cases loans can be divided into two or more tranches, where the green tranche (which is applied towards financing (or refinancing) eligible Green Projects) may enjoy a discount compared to the non-green tranche of the loan.

**Categories for eligible Green Project are listed in the GLPs*

# Sustainable Finance - Green Loans vs. Sustainability Linked Loans

- **Sustainability Linked Loans** (also called ‘greening loans’), on the other hand, which are defined in the SLLPs as “*any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower’s achievement of ambitious, predetermined sustainability performance objectives*”, are a more recent development and fills an important gap in the market for sustainable finance.*

- The core components of Sustainability Linked Loans (according to the SLLPs) are:
  - Relationship to Borrower’s Overall CSR Strategy (*should be clearly communicated to lenders*),
  - Target Setting (*SPTs should be ambitious and meaningful to borrower’s (core) business*);*
  - Reporting (*transparency; maintain up-to-date information relating to SPTs*); and
  - Review (*external review is encouraged, especially if information on SPTs are not publicly available*).

**In some circumstances an external reviewer can be engaged to determine if SPTs are ambitious for the borrower and the borrower’s business. Alternatively an external ESG rating can be sought.*

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# Sustainable Finance - Green Loans vs. Sustainability Linked Loans

- The main difference between a Green Loan and a Sustainability Linked Loan is that there is no green use of proceeds requirement for a Sustainability Linked Loan; instead Sustainability Linked Loans look to improve the borrower's sustainability profile by aligning loan terms to the borrower's performance against the relevant predetermined sustainability performance targets (SPTs), and that the loan includes a pricing adjustment if the borrower achieves the agreed SPTs (and/or a penalty if the borrower fails to achieve certain agreed SPTs).
- It should be noted that there are no set sustainability criteria for Sustainability Linked Loans, which means that loan can (and should) be bespoke depending on the borrower's specific ESG objectives.* It should also be noted that whereas Green Loans support environmentally sustainable economic activity, Sustainability Linked Loans support a broader concept of sustainability, which also includes social and governance factors.

**The most common SPTs relate to carbon emissions, but also other such as energy efficiency and water consumption are common*

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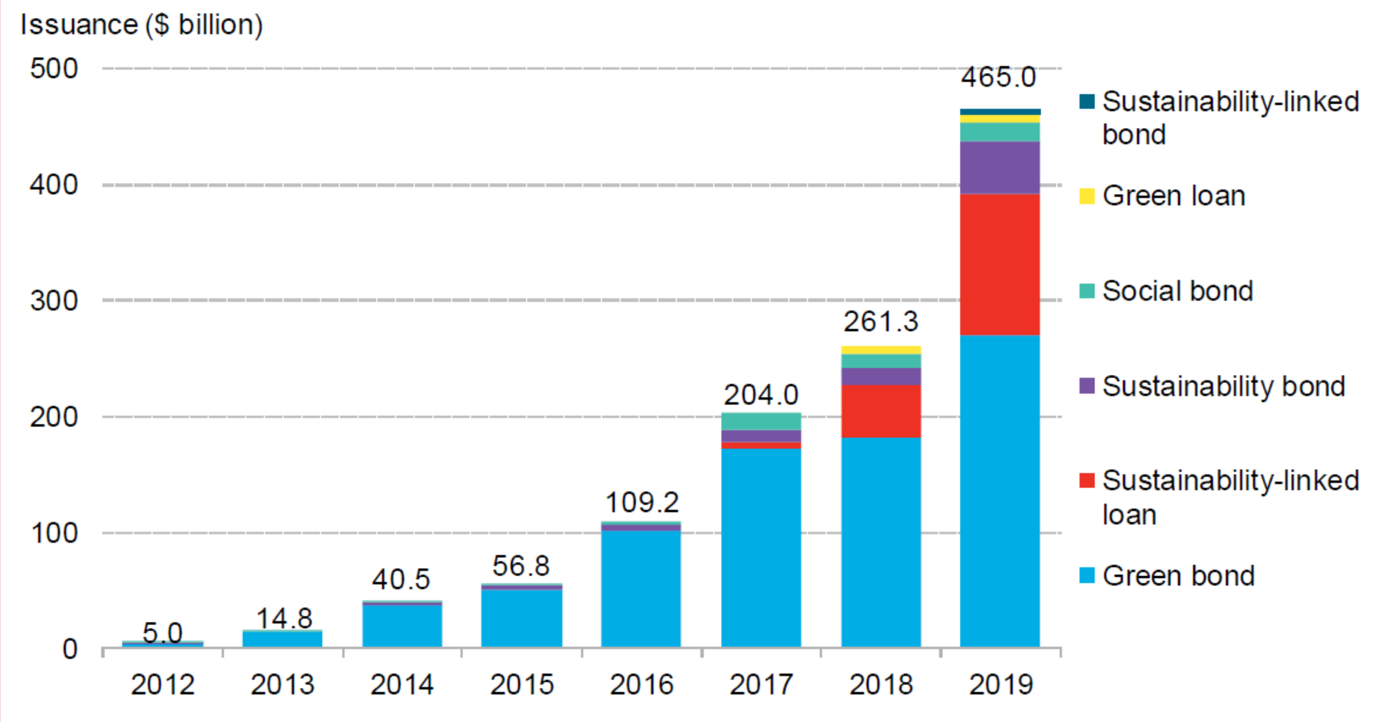
# Sustainable Finance - Green Loans vs. Sustainability Linked Loans – Key features

| | Green Loans | Sustainability Linked Loans |
|---|---|---|
| Aim | To facilitate and support environmentally sustainable economic activity | To facilitate and support environmentally and socially sustainable economic activity |
| Definition | Any type of loan instrument made available exclusively to finance/re-finance, in whole or in part, new/existing eligible Green Projects | Any types of loan instruments and/or contingent facilities which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives |
| Purpose | To finance Green Projects | No specific purpose |
| Impact on pricing | Traditionally not, but it is possible to have 'green tranches" that have a discount | Yes, one of the key characteristics with a SLL is a pricing adjustment if the borrower achieves the agreed SPTs |
| Pros | • Reputational benefit<br>• More flexible than green bonds | • Flexible (no use of proceeds requirement; other targets than environmental possible).<br>• Attractive for borrowers who do not operate in a green sector and have specific green projects, but still want to improve their sustainability<br>• Discount |
| Cons | Normally no pricing adjustment<br>Requires the borrower to have eligible Green Projects to finance | Potentially higher risk of greenwashing |

# Sustainable Finance - Market Activity

The market for sustainable finance has experienced an impressive growth since the issuance of the first green bond in 2007, and in 2019 a new global record for green bonds was set (USD 257.7bn total green bond issued). While the sustainable finance market has so far been dominated by green bonds, the market for green and sustainability linked loans is growing rapidly and taking a larger share of the 'green pie'.




*Source: Bloomberg NEF*

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# Sustainable Finance - Documenting Green Loans and Sustainability Linked Loans

- Although green and sustainability linked loans are not legal constructions as such, there are some aspects that will need to be taken into consideration when drafting and negotiating the finance documents for green and sustainability linked loans.
- The fact that the loan is green or sustainability linked will impact the purpose and use of proceeds clauses (in respect of Green Loans), and additional representations, general undertakings and information undertakings (so called ‘green covenants’) will need to be introduced into the loan agreement, which in each case will need to be tailored for the specific business of the borrower, the Green Project (in the case of a green loan) and the SPTs (in the case of sustainability linked loans).

# Sustainable Finance - Documenting Green Loans and Sustainability Linked Loans

- These are not in general problematic from a legal perspective, but the question is how a breach of these provisions are treated. A failure to reach a SPT in a Sustainability Linked Loan will normally lead to an increased margin (loss of the discount), but a breach of a specific 'green undertaking' or 'green representation' in a Green Loan does not normally lead to an event of default, instead will only have a negative effect on the relationship between the lender and the borrower as well as reputational damage for the borrower.
- There are currently no standardised provisions for documenting green and sustainability linked loans, and it is very unlikely in my view that (for instance) LMA will launch any standardised facility agreement or provisions on these, but it is possible that as the market develops, we will see more standardised provisions in the documentation for green and sustainability linked loans going forward.

# Sustainable Finance - Documenting Green Loans and Sustainability Linked Loans

- One issue in relation to green and sustainability linked loans has been that there has so far been no standardised definition for what is green and what is sustainable, and what constitutes green or sustainable for one lender may not constitute green or sustainable for another lender, which has increased the risk of greenwashing. This will most likely change in the near future once the EU Taxonomy, which is the cornerstone of EC's Action Plan on Sustainable Finance, will become effective, as that will establish a common language and define the categories of economic activities that are considered environmentally sustainable.

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# Sustainable Finance - What's Next?

- While it is impossible to predict the future, I believe that it is a fair assumption that the market for green and sustainable finance will continue to grow significantly in the following years.
- When discussing the market for sustainable finance going forward, it is meaningful to say a few words about the upcoming EU Taxonomy.
- In March 2018, the EC adopted an Action Plan on Sustainable Finance. The cornerstone of the Action Plan on Sustainable Finance was the establishment of a '**EU Taxonomy**', which is a classification tool creating a unified classification system on what can be considered an environmentally sustainable economic activity (i.e. creating a definition on what is "green").*

**The EU Taxonomy applies on (i) member states and at EU level to apply the Taxonomy when regulating how environmentally sustainable financial products or corporate bonds are made available, (ii) on "financial market participants" to make statements about alignment of investments with the Taxonomy, and (iii) on large public-interest entities to include information about how their activities align with the Taxonomy in the non-financial disclosure part of their financial statements*

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# Sustainable Finance - What's Next?

- A final text for the Taxonomy Regulation (the regulation on the establishment of a framework to facilitate sustainable investment) was agreed on 17 December 2019, and the delegated act on the first two climate-related objectives (climate change mitigation and climate change adaptation) should be adopted by the EC by 31 December 2020 and should therefore apply from 31 December 2021. The delegated act on the remaining four environmental objectives should be adopted by the EC by 31 December 2021 and should therefore apply from 31 December 2022.*
- The EU Taxonomy will without doubt have a significant impact on the market for green and sustainable loans and will create a more aligned market with a common language, which will help investors and companies evaluate if and to what extent an economic activity is environmentally sustainable and in particular minimise the practice of greenwashing.

**The remaining climate-related objectives are (i) Protection of water and marine resources, (ii) Pollution prevention and control, (iii) Transition to a circular economy, and (iv) Protection and restoration of biodiversity and ecosystems*

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# Sustainable Finance - What's Next?

- It is also worth mentioning that the Taxonomy Regulation also includes an extension to the reporting requirements via the Non-Financial Reporting Directive, imposing obligations on certain 'Large Public-Interest Entities' to report how and to which extent the undertaking's activities are associated with activities considered Environmentally Sustainable, as well as amendments to the Disclosure Regulation including disclosure rules on sustainability on 'financial market participants'.
- So far, the provision of sustainable finance has not been associated with any financial benefit, but let's see whether there will be a 'green supporting factor' for capital reserve requirements, as considered by the European Parliament and Commission, but which has been criticised by many.
- Will we see a 'Green Loan Standard' or a 'Sustainability Linked Loan Standard' like the Green Bond Standard going forward?

# Thank you!


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# Contact

## Berndt Pettersson

Partner / Advokat

Email: berndt.pettersson@delphi.se
Phone direct +46 8 677 54 85
Mobile +46 709 25 25 85