Norton Rose Fulbright

ESG | Sustainability

Responsible Capital: An ESG Loans insights report

Introduction

The market for green loans, sustainability-linked loans (SLLs) and social loans (collectively, ESG Loans[1]) is growing rapidly. However, it is moving so quickly that it can be hard to get a grip on market trends. We have developed an online platform which helps provide a more complete, and data-driven, picture of the market.

Early in 2022, we started gathering and structuring key data on the ESG Loans our EMEA offices have advised on. We worked with our innovation programme (known as NRF Transform) to develop an online platform to collect, store and analyse the data.

We are now ready to share our first insights based on the data we have gathered in over 50 ESG Loans across Europe, the Middle East and Asia-Pacific. We plan to provide further and more in-depth insights as our data set grows.

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1 The term specifically refers to financing transactions that adhere to the principles set by the key loan associations under their Sustainability-linked Loans, Green Loans and Social Loans principles.

Chart 1

Industry sectors

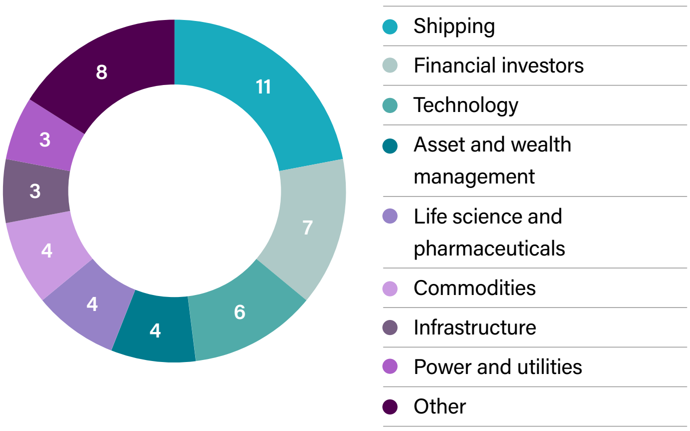
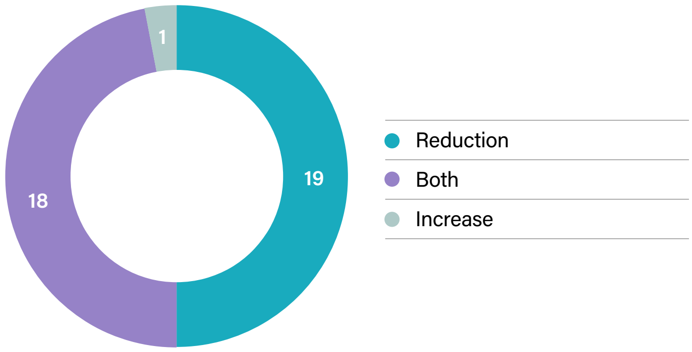


Chart 2

Types of margin adjustments on SLLs



As a large law firm, we work in a wide variety of sectors. As we would expect, given the ubiquity of ESG and sustainability in recent years, we are seeing ESG Loans across all industry sectors.

It is notable that shipping and financial investors are the most common sectors in our data set. Clients in both of these sectors have embraced the opportunity to borrow ESG Loans to show their sustainability credentials and to decarbonise their businesses. For both sectors, the vast majority of these ESG Loans were SLLs. This makes sense given the fact that SLLs do not have a "use of proceeds" requirement, so are more readily accessible than green loans.

Based on our data, we have seen lower number of ESG Loans from resource-intensive industries (commodities, power and utilities and oil and gas), but we expect that to increase as transition plans for companies in these sectors develop.

Green loans in particular are being utilised in the renewables sector and SLLs and social loans are of interest to those in the commodities sector, particularly for supporting low income farmers and producers in improving crop yields (which is one SLL we have worked on).

The Sustainability-Linked Loan Principles (SLLPs) provide that a key characteristic of an SLL is that an "economic outcome" is linked to whether the relevant sustainability targets are met. The SLLPs do not specify what that "economic outcome" should be. In practice, in the vast majority of cases, that outcome is an adjustment to the Margin.

In the early days of SLLs, we generally saw downward-only Margin adjustments. This made SLLs popular with borrowers because there was no risk of a price increase, regardless of their sustainability performance. However, in the last year or so, we are increasingly seeing lenders insist on Margin increases for bad performance along with Margin decreases for good performance (known as two-way Margin adjustments). While this is not required by the SLLPs, lenders are using two-way Margin adjustments in an effort to bolster the integrity of SLLs as a whole.

Our data set shows a fairly even split between "downward-only" and two-way Margin adjustments*. As our data set grows, we hope to track changes in Margin treatment in SLLs over time. We expect to see more two-way Margin adjustments in future.

* The "increase only" ESG Loan included in Chart 2 was due to the particular circumstances of that loan. Essentially, the transaction was structured so that the Margin would not be adjusted if the sustainability targets were met, but would increase if they were not met.

Chart 3

Type of margin adjustments by region

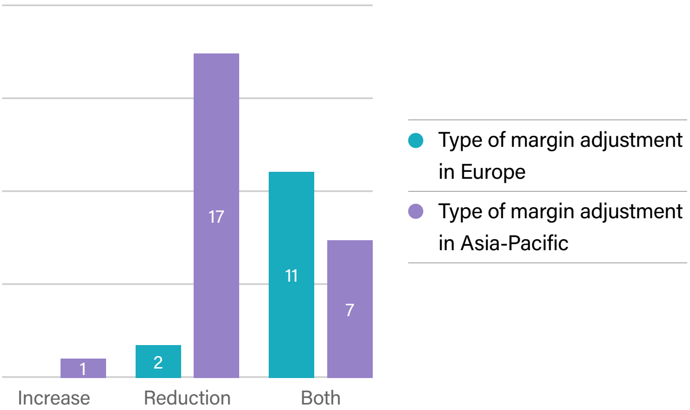


Chart 5

Type of margin adjustments in Asia-Pacific

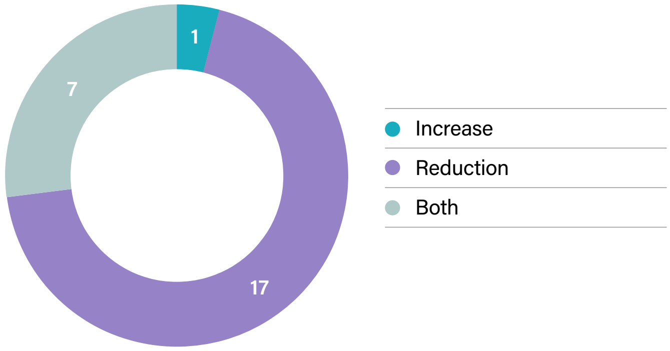
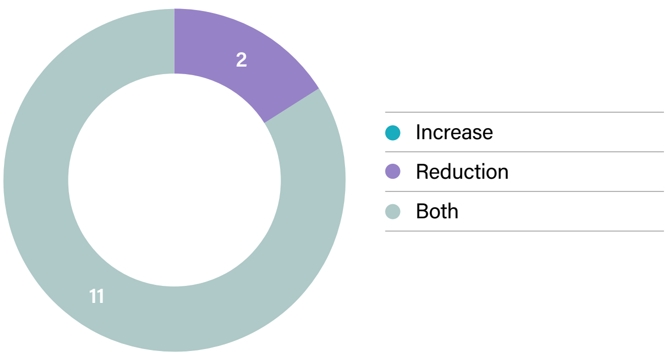


Chart 4

Type of margin adjustments in Europe



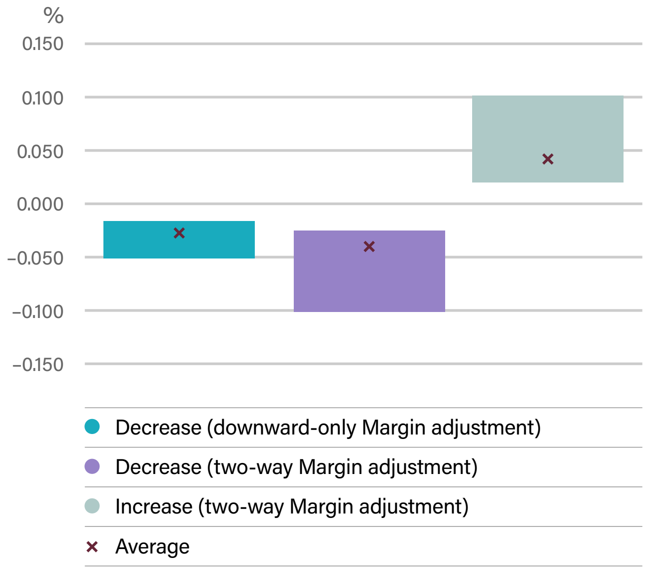
Our data shows a significant regional difference between the types of Margin adjustment in Europe compared to Asia-Pacific. In Europe, a two-way Margin adjustment seems to have become the standard for SLLs, whereas a one-way downward Margin adjustment seems to be the norm in Asia-Pacific.

As mentioned previously, the SLLPs do not require a two-way Margin adjustment. However, based on our data set it appears that lenders in Europe have been quicker to take a harder line on this issue than their counterparts in Asia-Pacific.

We expect that two-way Margin adjustments will become standard in Asia-Pacific soon, and there are indications that the market is starting to move that way already. As our data set grows, we hope to track these breakdowns by region and sector more deeply to provide further insights.

Chart 6

Spread of margin adjustments on SLLs



The overall story from our data is that Margin adjustments are generally very small in SLLs – typically a few basis points (1 basis point being 0.01%).

However, one feature we did not expect to see is that there is generally a wider spread of Margin adjustments for two-way Margin adjustments compared to SLLs with downward-only Margin adjustments. It is not immediately clear why this should be the case, but perhaps lenders are willing to allow for a greater downside (i.e. decrease of loan margin), if they also get the benefit of a upside (i.e. increase in loan margin).

It is worth noting that increases in Margins in SLLs (for poor sustainability performance) can cause a conundrum for lenders. Whilst receiving a higher rate of interest would normally be welcomed by a lender, for reputational reasons, a lender may not want to be seen to be profiting as a result of poor sustainability performance of a borrower. So what should happen to the increased interest?

We have sometimes seen documentation which addresses this issue by providing that Margin increases are to be set aside and donated to charity. On its face, this is an elegant solution. However, in practice it can cause lenders further difficulties, as it then puts the onus on lenders to ensure that (a) the charity in question is doing good work and (b) the funds are actually being deployed in the intended manner.

Other solutions to this problem include having the borrower set the extra money aside and apply it for an agreed green/sustainable project (which may or may not relate to the sustainability performance targets in the ESG Loan). This adds an administrative burden to the lenders in monitoring use. In other cases, lenders will simply accept the extra interest. We will continue to monitor how this issue is dealt with as the ESG Loan market matures.

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