NORTON ROSE FULBRIGHT

ESG | Sustainability

Responsible Capital: An ESG Loans insights report

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Introduction

Welcome to the second edition of our ESG Loans Insights Report.

The market for green loans, sustainability-linked loans (**SLLs**) and social loans (collectively, **ESG Loans**) continues to grow 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.

Since early 2022 we've been gathering key data on the ESG Loans which 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.

You can find our first ESG Loans Insights Report here. The current report is prepared based on the data we have gathered in over 60 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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Chart 1

SLLs dominate

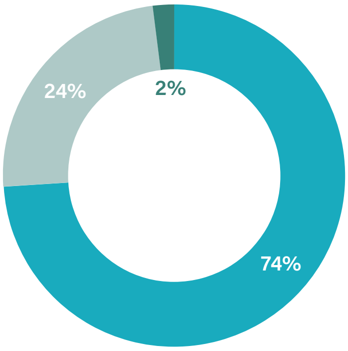
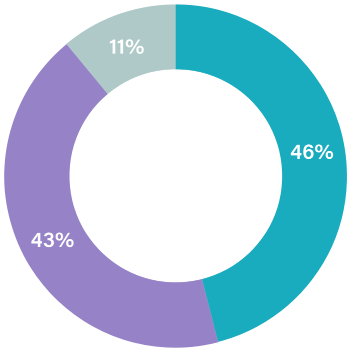


Chart 2

Declassification Event trigger



While the sustainable lending market started with green loans, it really accelerated when the sustainability-linked loan principles (**SLLP**) were launched by the Loan Market Association, Asia Pacific Loan Market Association and Loan Syndications and Trading Association in 2019. Our data shows that sustainability-liked loans (**SLLs**) are the sustainable finance instrument of choice for many companies.

There are a number of reasons for the popularity of SLLs amongst borrowers, including:

- **Accessibility:** unlike green or social loans, SLLs do not have a "use of proceeds" requirement, which opens up SLLs to a much wider range of potential borrowers. So long as a company is prepared to develop a sustainability strategy, it could potentially borrow an SLL, regardless of use of proceeds. Working capital loans or revolving facilities can also be structured as SLLs which opens up many more opportunities than only term loans for companies to benefit from developing an SLL.
- **Reputational benefit:** borrowers often receive positive publicity when they announce details of an SLL.
- **ESG signal to stakeholders:** borrowing an SLL sends a signal to investors, employees and other stakeholders that the company is serious about its sustainability journey.
- **Margin reduction:** if a company meets its sustainability targets, the interest margin will generally reduce. However, as noted in our first ESG Loans Insights Report, while the margin adjustment could be as much as 20 or 25 basis points, it is generally in the region of 5 or 6 basis points, so not a huge reduction.
- **Promotion by banks:** banks are actively promoting SLLs amongst their customers as they seek to clean up their loan books in order to make good on the net zero commitments they have made.

None of the ESG Loans in our data set provide for an Event of Default to occur if there is a breach of the green/social/sustainability-related provisions (although at least one green loan had a more granular purpose clause that needed proof of expenditure on green qualifying assets or would risk defaulting). Instead, ESG Loans invariably include the concept of a **Declassification Event**. One of the criticisms sometimes made about ESG Loans is that they lack "teeth". If ESG Loans could be said to have any "teeth" at all, they would be very small and blunt, and can be found in the Declassification Event concept.

It is our view that, as we see the development of mandatory non-financial reporting in a number of countries, with better verifiable datasets, it will not be long before we see events of default linked to failure to achieve ESG metrics. Financial institutions will also need the ability to default and exit relationships in the future to achieve their own net zero commitments, which will also be a driving factor to the change we anticipate over the next few years.

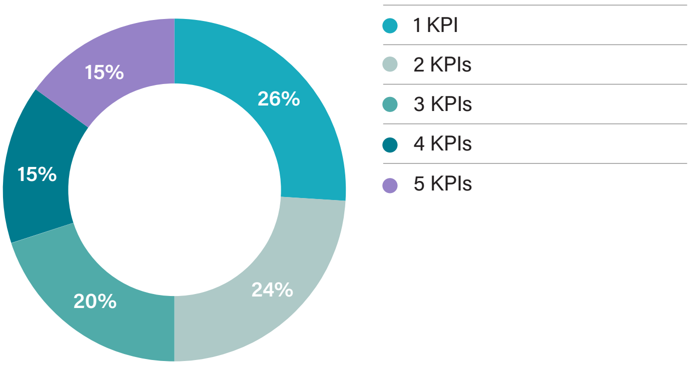
For now though, if there is a breach of the green/social/sustainability-related provisions, this will trigger a Declassification Event rather than an Event of Default. This will require the borrower to cease making any public statements about the green/social/sustainability-linked nature of the ESG Loan.

If a borrower fails to comply with this requirement following a Declassification Event, generally an Event of Default would be triggered. However, in some cases there will be no Event of Default but the Lenders will instead have an express right to make public statements about the declassification of the relevant ESG Loan.

But how can a Declassification Event be triggered? Our data shows a fairly even spread between an automatic trigger upon the relevant breach, and the trigger occurring upon the Agent's notice to the borrower. Where the Agent's notice triggers the Declassification Event, it is generally acting on the instructions of the Majority Lenders, but in a minority of cases this would be an all Lender decision.

Given the relatively limited consequences of a Declassification Event occurring, in the past we would often see an automatic trigger. However, we are increasingly seeing the Agent's notice approach, because lenders prefer to have control over the process (particularly as a breach may not always be clear-cut).

Chart 3
Number of KPIs

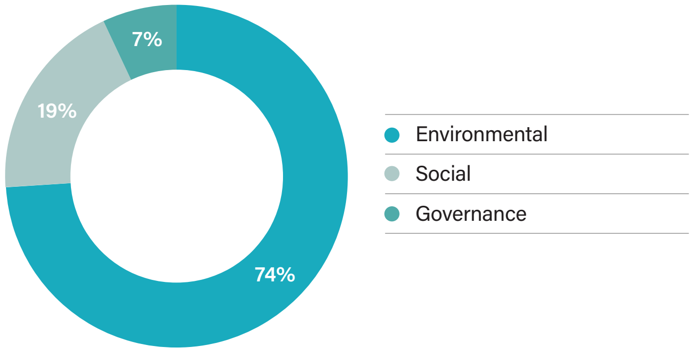


At the heart of an SLL is the selection of Key Performance Indicators (or KPIs) and related Sustainability Performance Targets (or SPTs) against which the sustainability performance of the borrower will be assessed over the life of the loan.

There is no "one size fits all" approach, and the latest updates to the SLLPs emphasise the need for KPIs and SPTs to be meaningful, ambitious and robust, including by going beyond regulatory required targets and being benchmarked in the market where possible. You can find our summary of the latest changes to the SLLPs here.

The SLLPs don't specify how many KPIs should be included, or which elements of E, S and G should be covered. Our data shows a fairly even spread of SLLs having anywhere between one and five KPIs, but as time goes on we expect to see fewer SLLs having just a single KPI.

Chart 4
KPIs in each ESG category



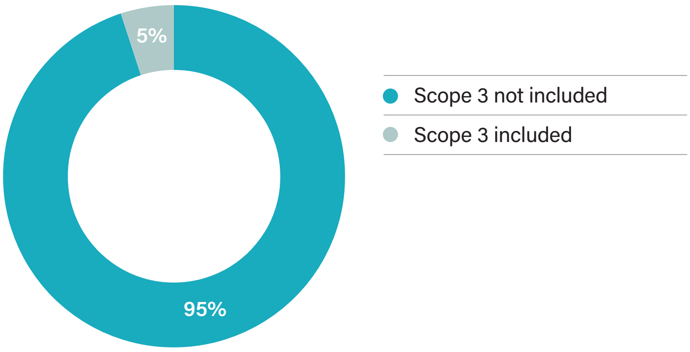
Around three-quarters of the KPIs in our data set fall into the environmental category, with the remainder mainly in the social category and (to a lesser extent) the governance category.

There are a number of reasons for this, including the understandable emphasis given to climate change and the desire to align with the climate-related goals of the Paris Agreement. In addition, some categories of environmental KPIs are inherently easier to quantify (e.g. electricity consumption) than more qualitative KPIs that might apply in some social categories (e.g. impact on indigenous population).

However, we are increasingly seeing social and governance KPIs included in SLLs, and expect this trend to continue as businesses focus on the broader concept of sustainability, not just environmental issues.

Chart 5

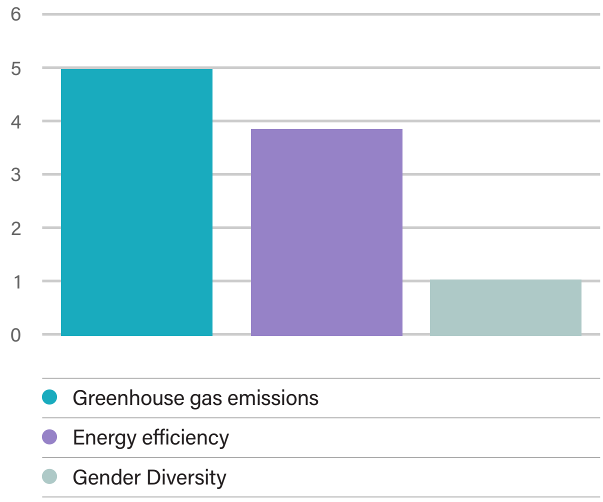
Proportion of greenhouse gas emissions KPIs mentioning Scope 3



Many of the KPIs in our data set relate to greenhouse gas emissions. Of those, most focus on so-called Scope 1 (i.e. direct emissions arising from a company/group's own operations) and Scope 2 emissions (i.e. indirect emissions from the generation of electricity used by the company/group in its operations). KPIs in respect of Scope 3 emissions (i.e. indirect emissions arising from a company's value chain (both upstream and downstream)) are much less common. Scope 3 emissions are much harder to calculate, largely because of the need to gather (accurate) data from a potentially wide variety of supply chain partners who may not already be collecting that data or may not be willing to share it. The SLLs we have seen which include an element of Scope 3 emissions in their KPIs are all in the **shipping** sector, by companies who are following the framework developed by the Science-Based Targets initiative for the maritime sector.

Chart 6

Gender diversity in shipping



The **shipping** sector is an interesting case study for other reasons. Until a couple of months ago, all of the KPIs we saw in shipping SLLs were in relation to energy efficiency and/or greenhouse gas emissions. However, in March 2023, we advised the lenders on an SLL which included a KPI on the number of women holding leadership roles at a shipping company. We believe this may be the first instance of a gender diversity KPI in a shipping SLL. You can find more information on the emerging trend of gender diversity in shipping loan agreements here.

For more insights from Norton Rose Fulbright on ESG and sustainability issues, please subscribe to our ESG Sustainability newsletter here.

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