NORTON ROSE FULBRIGHT

ESG | Sustainability

Responsible Capital: An ESG Loans insights report

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Introduction

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

The market for green loans, sustainability-linked loans (**SLLs**) and social loans (collectively, **ESG Loans**) continues to mature at pace. However, it is often 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 previous ESG Loans Insights Report here.

The current report is prepared based on the data we have gathered from ESG Loans across Europe, the Middle East and Asia Pacific issued in 2023. We plan to provide further and more in-depth insights as our data set grows.

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Market overview

2023 was a more challenging year for sustainable finance. Following on from two 'bumper' years of issuance in 2021 and 2022, at the outset of 2023 most expected that the market would continue to grow. However, SLL issuance dramatically slowed in the latter half of 2023 to nearly half the corresponding 2021 numbers. This decline can be partially attributed to the general decrease in activity across loan markets as lenders and borrowers grapple with macro-economic issues in a sustained high interest rate environment.

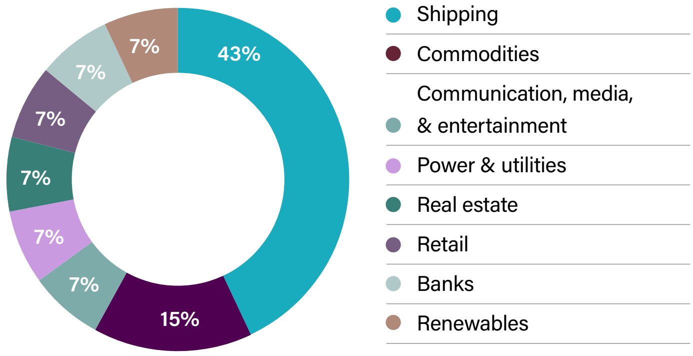
Even in a quieter market, SLLs showed resilience, continuing to be the instrument of choice compared to green loans and social loans. There are several reasons for the popularity of SLLs, including:

- **Structure and 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, so the instrument is not limited to term loans.
- **Reputational benefit:** borrowing an SLL sends a positive, public signal to investors, employees and the market that the company is committed to its sustainability journey.
- **Investor / stakeholder requirement:** increasing regulation and concerns about the detrimental effect of climate change and social inequality means more investors and stakeholders are putting pressure on their investments and portfolio companies to demonstrate compliance or clear efforts to improve their sustainability.
- **Cost of capital:** if a company meets its sustainability targets, the interest margin on the loan will generally reduce. However, as noted below, while the margin adjustment could be as much as 20 or 25 basis points, it is generally in the region of 5 to 10 basis points, so not a huge carrot or stick. In addition, failure to meet sustainability targets often results in a margin increase.
- **Settling of documentation:** in May 2023, the Loan Market Association published their Draft Provisions for Sustainability-Linked Loans and accompanying Term Sheet for Draft Provisions for Sustainability-Linked Loans (the **LMA Draft Provisions**), providing a common starting point for drafting of SLLs.

Market trends

Chart 1

Sectors



Shipping steams ahead

Often seen as a 'hard to abate' sector, the number of SLLs issued to borrowers in the shipping sector has exceeded previous years. One of the reasons for this may be due to the target-based regulatory framework, which now provides for multiple checkpoints along the industry's road to net zero by or around 2050. If borrowers can demonstrate that they are at, or just ahead of, the trajectory required to meet these targets, then it is possible to characterise loans as SLLS.

Whilst the data points towards an industry which is increasingly focused on decarbonisation, we do not read too much into the dominance of shipping SLLs versus SLLs in other industries in our dataset, which may partly be attributable to our Firm's large international shipping finance practice. This trend builds upon our findings in earlier reports that energy efficiency and reducing the carbon intensity of shipping, alongside gender diversity, have been a focus of KPIs in this sector.

Such increase could be attributed to the development of international regulatory frameworks and the greater availability of technologies to aid compliance and reporting specifically in shipping. Initiatives such as the Poseidon Principles (a reporting framework for the climate alignment of financial institution's shipping portfolio) have encouraged this as lenders are now increasingly focused on lending into "greener" projects and financing more environmentally friendly vessels in order to ensure that their book of business falls within the regulatory requirements. The development of technologies used in decarbonisation solutions for ship owners continues to build confidence, with the possibility of such technology itself being funded by green loans.

Chart 2

One-way versus two-way margins

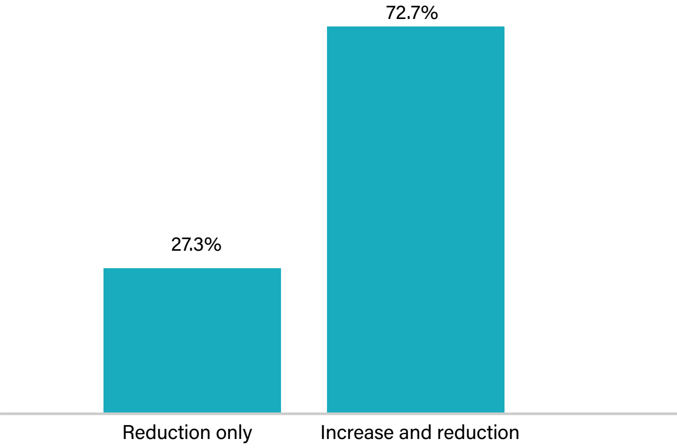
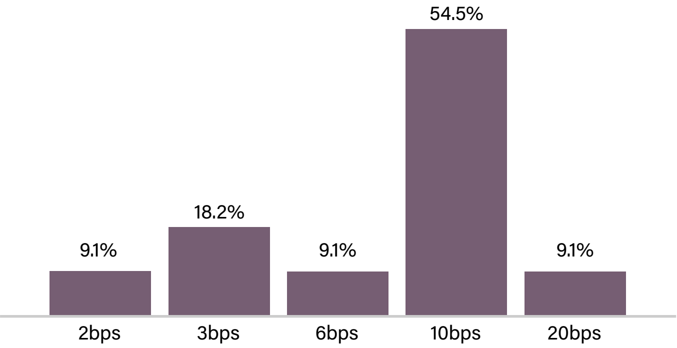


Chart 3

Discount / premium variance



Margin mechanics

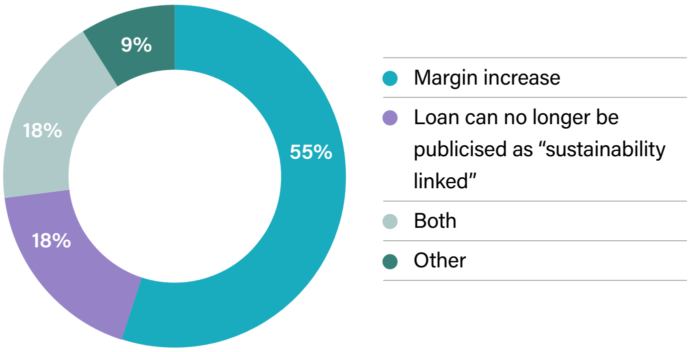
In 2023, two-way ratchets (where the borrower can receive a margin reduction for good performance ***or*** incur a margin premium for failed or under-performance) featured more than one-way (where only a discount occurs). Commercial positions and mechanics vary amongst transactions. However, with the settling of the SLL format and establishment of surrounding infrastructure (including reporting frameworks), borrowers are getting more comfortable having both a financial benefit and detriment (albeit minimal) attached to their sustainability targets.

The cumulative adjustment of margin ratchets tightened in 2023 compared with the previous years, ranging from +/-2 bps to +/-20 bps. Whilst many commentators predicted an increase in the ratchet offered as the SLL market matured, lenders held firm with the exception of those with a specific impact mandate.

Considering modest margin mechanics, parties who have the flexibility to do so are looking at other avenues to make an SLL appealing to borrowers. Such alternative benefits can include strategic sustainability partnerships, tailored training and advice, increases to baskets and contributions to the cost of reporting.

Chart 4

Consequences of breach



Under the LMA Draft Provisions, (i) non-compliance with SPT reporting and verification obligations and (ii) misrepresentations as to the accuracy of any sustainability information (including in respect of SPTs) would constitute a "Sustainability Breach". For example, failure to retain the services of a sustainability-verifier (to undertake the reporting verification required by the LMA principles) with sufficient time ahead of SLL reporting deadlines.

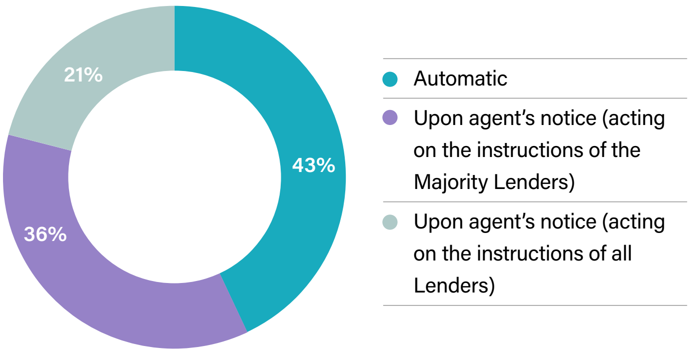
From our data set, no SLLs triggered a default or event of default on a Sustainability Breach alone. Most SLLs triggered a margin increase, which reflects the position in the LMA Draft Provisions.

Borrowers often push back against any margin increase for a Sustainability Breach, the argument being lenders should not receive additional income where it is not clear whether a SPT has been achieved or missed. However, the purpose of such provision is to protect the integrity of the product and protect against greenwashing – if a borrower signs up to an SLL, it should be prepared to comply with the required provisions and cannot just enter for the reputational benefits without performing the SLL obligations. Additionally, the accrual of the margin increase is often time limited and curtailed on a Declassification Event or remedy of the breach.

The second most-popular option was to restrict the borrower's ability to publicise the loan as an SLL following a breach. We would now usually see this in the declassification clause (outlined below), as such provisions usually require borrowers to cease publicising the loan as an SLL. Borrowers would also argue that such a permanent consequence is not appropriate for a potentially remediable SLL breach. For example, a short delay in the delivery of their reporting would trigger the publicity scrubbing exercise outlined above. So whilst a small margin increase is acceptable for such a hairline trigger, permanently revising public statements (especially if they are likely to be reinstated) is not.

Chart 5

Trigger for declassification



With SLLs generally being out of reach of Default/ Event of Default regimes, finance parties must rely on Declassification Events to protect them from accusations of greenwashing and borrower misbehaviour. A common exception to this rule is any non-compliance with the obligations placed on the borrower following declassification, such as no longer publicising the loan as sustainability-linked. In these limited circumstances an Event of Default would generally arise.

As referred to above, unlike Defaults/Events of Default, the occurrence of Declassification Events 'switch off' any margin ratchets and related SLL provisions whilst requiring borrowers to ensure no further publication referring to its loan as an SLL. Whilst not in the LMA Draft Provisions, we have occasionally come across wording explicitly requiring borrowers to make a public statement regarding declassification, a provision which many sponsors and borrowers with broader sustainability strategies push back against.

Declassification triggers we often see include (i) a Sustainability Breach (outlined above) continuing unremedied for a certain period of time (including, for example, failure to deliver annual sustainability reports for two consecutive reporting periods) and (ii) failure to agree any revised KPIs or SPTs following a substantial change to the borrower's circumstances (including through M&A and disposals). The LMA Draft Provisions include the latter circumstances but advise parties to consider further potential Declassification Events on a case-by-case basis in the context of the deal and market practice.

Once a Declassification Event has occurred, our data set showed a fairly even split between three possible consequences:

i. automatic declassification of the SLL;
ii. declassification of the SLL upon Majority Lender instructions to the Agent; and
iii. declassification of the SLL upon all Lender instructions to the Agent.

The data on this point was truly varied throughout the three options, reflecting differences in the bargaining power between the parties in SLL negotiations. The LMA Draft Provisions leave the question for parties to determine, including an option for declassification to be determined on either Majority Lender or all Lender instruction.

The declassification and default dynamics differ where a lender is, for example, a credit fund which is subject to financial regulation (such as SFDR article 9) pursuant to which its investment must have a clear objective of generating a positive sustainable impact. Failure by a borrower to pursue and achieve SPTs under an SLL issued by a regulated lender puts the clarity of that objective in question. We expect to see some such lenders affected by regulation to include SLL Events of Default, affording them transferability rights and greater flexibility to re-allocate capital in to maintain compliance with their regulatory obligations.

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