THE EVOLVING SCOPE OF SUSTAINABLE FINANCING

In our Q4 2018 Corporate Borrower Update, we considered the growth of green financing in general, i.e. financing (whether that be bonds, equity or debt) that supports or encourages environmentally sustainable economic behaviour, and then provided more focused commentary on green loans. In this edition, following publication by the Loan Market Association (**LMA**) of its Sustainability Linked Loan Principles (**SLLP**), hot on the heels of its revised Green Loan Principles (**GLP**), we consider the general scope of sustainable financing, how it differentiates itself from green financing and the GLP, what is meant more specifically by sustainability linked loans and what these could mean for corporate lending.

What does sustainable financing currently encompass and how does it differ from green financing?

Until recently (and perhaps still) the terms 'sustainable financing' and 'green financing' have been used interchangeably to refer to financing that supports and promotes economic activity with environmentally sound objectives. However, as objectives, principles and guidelines, terminology and industry awareness has evolved to create a more sophisticated market of financial products in this area, the distinction between sustainable financing and simply green financing has become clearer.

At its core sustainable financing still has environmental objectives and concerns similar to those that drive, and are captured by, green financing but it casts the net even wider to take account of social and governance objectives too (together known as Environmental, Social and Governance (**ESG**) standards). In a practical corporate lending context, this may include not only taking account of, for example, a corporate borrower's contribution to CO2 emissions or water usage within its business but also the working conditions of its employees and its internal approach to corporate governance issues.

Publication of the SLLP by the LMA has arguably helped significantly in clarifying this distinction for industry participants. In our previous article on green financing we outlined how the key focus in a GLP compliant green loan is the 'use of proceeds', i.e. the requirement that the proceeds of the loan be invested into projects, activities or assets that have a specified environmental benefit (for example eco-efficient products, production technologies or processes). We also noted though how participants in the loan market are already devising commercial concepts and documentary mechanisms that mean that, although such loans do not technically meet GLP requirements, they nonetheless provide a financial incentive for the borrower to engage in environmentally responsible or 'green' behaviour.

The SLLP have both formalised this concept of incentivising borrowers to engage in environmentally friendly behaviours and widened the scope of that incentive to encompass and encourage more all-round ESG friendly behaviour. The formal form of incentive will usually be financial, i.e. sustainability performance objectives (e.g. relating to CO2 emissions, water usage, sourcing of sustainable raw materials or supplies, recycling, production of sustainable products and/or improvements in the borrower's overall ESG rating or achievement of a recognised ESG certification) and will be predetermined and incorporated into the loan documentation in the form of covenants that in turn are tied to a reducing margin ratchet. Note that incentive is the key word and failure to meet the sustainability linked covenants will not result in a breach or trigger an event of default - it is not intended to be used as a stick.

The informal incentive for all participants, is an improved positive public imagine and business development opportunities. Sustainability linked loans naturally open up the door to these evolving new loan products to a much wider group of corporate borrowers than the strict use of proceeds approach supported by the GLP might otherwise have done. However, it is worth highlighting that the requirements and objectives of the GLP and SLLP are not mutually exclusive. There is nothing stopping borrowers and lenders striving to incorporate both into their loans, although of course this will understandably only be possible in a narrow group of transactions.

With these new sustainably linked products come potential new roles in the financing cycle. For example, the need for a new internal officer role within businesses to devise (if this has not been done by an external expert) an ESG strategy to pin sustainable covenants against, and to then implement, monitor and report on that strategy. In some instances though, internal expertise alone may not be considered sufficient; this will depend, for example, on the lender/borrower relationship and the sophistication and resources of the borrower. In some cases, a lender may wish to agree the appointment of an external reviewer to report independently on how a borrower is meeting its sustainability linked covenants. The SLLP does not set requirements or obligations for such new roles in stone, but helpfully it does offer guidance on these points for parties to consider on a deal-by-deal basis.

What are the benefits to corporate lenders?

As with 'use of proceeds' green loans, the benefits to the lender of providing a sustainability linked loan are that (i) they are associated with a type of financing that is being widely promoted across the globe by the TFCFD, the European Commission, the UK Government and industry bodies to ensure a successful transition to a low-carbon economy; (ii) corporates that engage in sustainability, are environmentally and socially conscious are viewed as a better credit risk, as such engagement arguably enhances their competitive advantage, increases their operational cost effectiveness, and ultimately, improves their long-term financial performance; and, (iii) more specifically, encouraging sustainability can often result in an increase in the value of a lender's security (for example improving the energy efficiency of a real estate asset could increase its market value or improving a borrower's corporate governance or public image could have a significant impact on the value of its business).

How can corporate borrowers take advantage of this?

As is evident from the 'noise' in the market around both green and sustainable financing there is clearly an appetite for improved ESG performance from both lenders and borrowers. This coupled with lenders' internal corporate and social responsibility requirements means borrowers could use the opportunity to obtain beneficial pricing. Public expectation of brands acting in an environmentally conscious manner is growing, and positive sustainable behaviour is a useful selling point to both stakeholders and customers.

Thoughts on the future of sustainable financing

Statistics, referenced at a recent LMA seminar, show that Europe as a whole is a leading market in the field of sustainable financing with 80% of all sustainable financing deals deriving from Europe; and in the Accelerating Green Finance Paper (prepared by the Green Finance Taskforce, an organisation established by the City of London Corporation) London is described as a world leading hub for green finance. There still remains great scope for growth and development in this field and these reports indicate that London and the wider European market will be leading the field on that front.

So far, voluntary measures and self-monitoring have moved the sustainability linked finance market forward but naturally this has led to inconsistencies in approach, standards and products and the appetite for engaging with sustainable issues in financing continues to vary across sectors and institutions. To ensure that sustainability is integrated across our national and international economies, and that a universal change in attitudes, approaches and implementation evolves, there clearly needs to be a move towards regulation, codification and perhaps even legislation both nationally and cross-border.

We have already seen movement in this direction. For example:

- the Task Force on Climate-related Financial Disclosures (**TFCFD**) (established by the Financial Stability Board - an international body created by the G20) has published recommendations aimed at addressing climate-related risks in governance, disclosure, strategy, risk management, metrics and targets, that are intended to be adoptable by investors and lenders;

- the EU strategy on sustainable finance developed by the High Level Expert Group on Sustainable Finance has put forward recommendations which have already started to be considered and implemented by the technical expert group (**TEG**) on sustainable financing. For example, a proposal has already been suggested for regulations dealing with unified taxonomy in relation to environmentally sustainable economic activity, disclosure requirements in respect of ESG factors and defining minimum standards for the methodologies of the 'EU climate transition' and 'EU Paris-aligned' benchmarks to address the risk of green-washing; and

- the UK government, as well as UK regulators (for example, the Prudential Regulatory Authority (**PRA**) and the Financial Conduct Authority) are examining various measures to integrate sustainable issues into financial decision making and embed climate risk into the regulatory framework.

Such formal guidance, monitoring and regulation will help address issues of inconsistencies across the financial industry but to further drive appetite there needs to be a formal and universal incentive too, for both lenders and borrowers. Clearly this won't come about overnight, but we are seeing that positive steps are already being taken. For example there are now central bank discussions taking place regarding sustainable supporting factors being taken into account in determining bank capital requirements. This is a big step forward to where we were even 12 months ago when such an idea was not yet being entertained.

So, could sustainable financing eventually become standard rather than a separate product? This certainly seems like a possibility in the face of changing social attitudes and the progress we have seen so far. An assertion supported by the recent

(March 2019) Sustainable Finance Progress Report issued by the UN, in which it was reported that sustainable financing was becoming increasingly mainstream and less of a niche offering, as a diverse range of financial players were found to be integrating elements of sustainability into financial decision-making in both public and private financial markets (including, development banks, institutional investors, commercial banks, insurers and some of the largest private equity firms). However, the key risk that all these players need to be live to and ensure is avoided is so-called 'green/sustainable washing', i.e. spinning the nature of a product to make it appear greener or more sustainably linked than it actually is in the drive to be seen to be making green and sustainable standard practice in financing. Consequently, progress may be slowed by the need to carefully engineer, monitor and regulate this evolving market but that of course should not be perceived as a negative – getting a universal framework in place and promoting improved data sharing and transparency will be key.

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