July 2019

REAL ESTATE FINANCE UPDATE

INTRODUCTION

Welcome to the July 2019 edition of the Addleshaw Goddard Real Estate Finance Update.

In this edition we look at the new non UK resident CGT charge that came into effect in April of this year, examining how it applies to both "direct" and "indirect" real estate disposal transactions and the particular issues that lenders might want to consider in light of its implementation. Click here to read this article.

2019 is proving to be a big year for legal technology as demonstrated, for example, by the recent inaugural Loan Market Association FinTech Conference. So, our in-house Innovation and Legal Technology Team comment on what legal technology means in general terms and then provide a focused look at some key forms of legal tech that have been causing waves recently, namely artificial intelligence and automation. Click here to read this article.

As 2021 approaches we summarise the current position regarding the replacement of LIBOR as a benchmark funding rate and highlight how it is crucial at this stage that consideration is given to the treatment of legacy products, including some thoughts on the issues that lenders may want to take into account. Click here to read this article.

Finally, following on from the article that considered the growth of 'green' financing, which appeared in our last edition of this publication, we take a look at the evolving scope and growth of sustainable financing, how it differs from green financing, what the benefits of being involved in this type of financing might be for lenders and borrowers; and what the future of sustainable financing might look like. Click here to read this article.

We do hope these articles are of interest – do not hesitate to contact any of the team if you would like to discuss or if there are topics which you would like us to address in future editions.

Steve Mackie – Head of Real Estate Finance
Steve.Mackie@addleshawgoddard.com
020 7160 3269

NEW NON-RESIDENT CGT CHARGE FOR DIRECT/INDIRECT UK REAL ESTATE DISPOSALS

What is the new non-resident CGT charge?

From April 2019 all non UK residents (whether companies, individuals, trustees or PRs) were (with limited exemptions available) made subject to UK taxation where they generate investment gains that are, directly or indirectly, attributable (in defined circumstances) to UK land.

The new rules apply to all disposals although, because there is a 'step up' in base cost to market value at April 2019, it will be a while before significant amounts of tax start being collected – see below for more detail. UK tax reporting requirements will apply to non UK residents, whether or not already registered with HMRC.

How does the non-resident capital gains charge apply to "direct" real estate disposal transactions?

The new legislation is only going to apply to those transactions where non UK residents are disposing of an 'interest in UK land' within the CGT rules, so for example, grants of long leasehold interests, as well as, sales of freeholds and sales of inferior property interests. However, this could apply to a significant number of transactions as a relatively high percentage of high value UK investment land is now owned by offshore entities, such as:

- offshore (Jersey, Guernsey, BVI, Cayman etc) companies,
- other non UK companies such as Dutchcos, Luxcos,
- Jersey (and other offshore) property unit trusts etc.,
- other types of offshore fund vehicles, especially in Luxembourg

Additionally, where the land is held by partnership vehicles (LLPs or LPs etc) it will be necessary to 'look through' the actual owner vehicle, to establish the identity and tax status/tax residence of the various partners. And of course real estate assets may well be owned by nominees (e.g. two English companies holding bare legal title) with beneficial interests sitting behind the title – and it is the beneficial owners (if non UK resident) on whom the new tax charge will bite.

The new legislation does not impose any additional obligations on buyers of UK real estate. Note this was not always going to be the case as at one stage of the process, there were HMRC suggestions that buyers, and also professional advisers, might have a reporting requirement imposed on them, or even possibly an obligation to withhold tax from the purchase price. However, since this is a fundamental change to a long standing UK tax benefit for non UK resident owners, prudent advisers to non UK resident purchasers of UK land interests are likely to be making their clients aware of this new charge.

Although, initially, tax amounts payable are likely to be small (given the April 2019 'market value' rebasing) it should be kept in mind that real estate values can 'spike' sharply based on events such as obtaining planning permission, securing a new tenant or increased rents following a rent review. So that significant amounts of tax could become payable relatively quickly in specific cases.

A particular issue with this rebasing to 2019 market value is that there is likely to be significant extra demand, in the near term, for RICS-standard valuation advice, in the months following introduction of the legislation – this may lead to difficulties in sourcing appropriate valuers, and of course the valuation will be needed quickly, to inform the necessary gain calculation and to support tax returns when made.

How does the non-resident capital gains charge apply to "indirect" real estate disposal transactions?

Be aware that a charge may also be imposed on corporate transactions – or 'indirect real estate disposals' - where there is a sale by non UK resident shareholders of interests in corporate entities that derive the requisite element of their value (i.e. at least 75% of its gross asset value – known as the 75% 'property richness test') from UK land. Most obviously this covers sales of (shares in) companies, but disposals of other types of entity are also potentially caught.

The shares being sold could be shares in a UK company, or shares in a non UK company. And the new UK tax charge extends to disposals all the way up the corporate chain: so that, for example, a sale by non UK resident shareholders of shares in a BVI company that acts as the holding vehicle for a Jersey company that in turn owns UK land will give rise to a UK tax filing and tax payment obligation for those non UK resident shareholders selling shares in the BVI holding company.

Funds Rules

In relation to 'fund' type entities there is a further area of complexity. Where the entity that is selling UK land is a 'collective investment vehicle' (as defined in the legislation), particularly if it is a 'collective investment scheme' (CIS) (which could, for example, be an offshore unit trust under the s235 FSMA 2000 test), then the selling entity may be able to make an election so that the CGT charge will instead be on the investors in the CIS rather than payable by the CIS itself. Open ended/overseas companies, as well as other types of non-corporate entities, may very well fall within this definition and the significance of this is that if the entity selling the land is a CIS and has made an election (as described above), all (non UK resident) non UK investors will have a UK tax filing / paying obligation (rather than just 25% plus owners).

This is a more complex area though and we do not propose to go into any further detail on it in this particular article.

Tax returns and compliance – a consequence of the new legislation

In consequence of the new legislation, non UK residents will be required, for the first time, to make UK tax returns to HMRC in respect of such investment gains: not only on direct sales of UK real estate but also on indirect sales (e.g. of shares in companies etc, or interests in fund vehicles), which principally derive their value from underlying UK real estate. Moreover, in some cases (particularly, where the non UK resident is not already registered with HMRC) the (on-line) returns must be made quickly (no later than 30 days after completion) and tax paid at that stage. A good deal of information and detailed calculations of the gain realised will need to be assembled in order to be able make these returns in timely fashion and to avoid penalties and interest. Not only will this be a challenge for sellers but the accelerated timescale within which UK tax will actually be paid to HMRC will have an impact on lenders (see below).

Particular points for lenders

As a general rule, tax on capital gains will only be payable if the value of the secured assets has gone up. So, in such cases, lenders' security would seem to be robust. There are, though, some particular points for lenders to consider:

- as a general principle a secured lender is a preferred creditor, so has a priority over HMRC's claims for 'ordinary' tax liabilities (e.g. tax on disposal). However, the accelerated period within which the new non UK resident capital gains tax may need to be calculated and paid by non UK resident borrowers can mean that actual cash will have left the borrowers bank accounts within a very short period after sale. Drafting in facility agreements for lender consent to sales, realisations accounts, and early pre-payment in case of disposals, needs to be reviewed in light of this;

- obtaining clarity as to April 2019 market valuations for secured assets will be (increasingly) important for lenders in order to assess the UK tax charge that will arise on future disposals (keep in mind that, in worst cases, it might be necessary to enforce the security and for the lender/its agents to realise the secured assets and arrange tax payments);

- onshoring: the absence of any UK tax charge on investment gains applying to non UK residents has, previously, been a major attraction for overseas investors and is one of the principal reasons why so much high value UK real estate is owned by non UK resident entities. Equally establishing and operating companies, unit trusts etc outside the UK involves additional cost and complexity. Now that the UK tax treatment, for non UK ownership and for UK ownership, has become essentially identical it may be difficult to justify the additional cost and complexity of running the asset owning entity outside the UK (though in some cases there may still be other reasons to do so). There is already evidence that some investors may be looking to 'onshore' existing offshore structures and lenders may be approached about this (e.g. for restructuring consents); and

- finally, in considering proposals for lending to non-residents, lenders will wish to take the impact of the new legislation into account. There are, within the legislation, targeted anti avoidance provisions and also 'overrides' to try to prevent 'treaty shopping'. Lenders will wish to assess critically the effectiveness of any structure claimed to avoid UK taxation, particularly in light also of any wider regulatory considerations, such as the UK Banking Code.

Should you wish to discuss any issues relating to this topic in more detail or seek advice on any of the issues raised by this change in tax legislation please contact one of the relevant Addleshaw Goddard representatives listed below.

Peter Sayer
peter.sayer@addleshawgoddard.com
020 7880 5792
07834 889 659

Steve Mackie
steve.mackie@addleshawgoddard.com
020 7160 3269
07921 417 457

LEGAL TECHNOLOGY AT ADDLESHAW GODDARD

The legal world is undergoing a period of unprecedented change. The industry is awash with buzzwords like 'artificial intelligence', 'automation' and 'blockchain', and at times it can seem impossible to sort the hyperbole from the practical application of these technologies to our industry.

But what exactly is 'legal technology'? The term encompasses a myriad of solutions but stripping it back, it means technology that has the power to streamline and automate existing processes, and revolutionise both how we work and in turn, beneficially impact how we deliver legal services to our clients.

At AG, we utilise tools such as artificial intelligence, document automation, online collaboration, data mining, project management and reporting to increase internal efficiencies and to build tailored products to assist our clients in quashing pain-points and meeting regulatory challenges (such as ring-fencing). By combining our vast industry knowledge and legal expertise with the most cutting-edge technology, we are able to deliver solutions that ensure matters run more smoothly, transactions can complete faster, document organisation is made easier, manual processes are automated and workflows are optimised.

AG are committed to staying at the forefront of these evolving technologies, and our dedication to this was demonstrated early on by the establishment of our award-winning Innovation and Legal Technology (ILT) Team in 2015. Over the last four years, since the ILT team's creation, we have witnessed a significant increase in the pace of change and adoption of legal technology and no more so than in the spaces of artificial intelligence and automation – an examination of which forms the focus of the body of this article.

Artificial Intelligence (AI) – Now and In the Future

Today

In its simplest form, artificial intelligence means computer systems which can replicate human functions. This can include neural networks and natural language processing, but most AI systems, particularly those used in the legal industry, rely on 'machine learning'.

For the most part, machine learning relies on 'supervised learning'. This involves humans (in our case, our lawyers) 'training' the AI tool by labelling and classifying data, such as various clause types. The system then analyses this dataset and identifies relationships within it, which means that it can then identify those clause types independently in the future, i.e. the system has been 'taught'. Results are then checked by human experts and the system further refined as needed.

So how does this work in a legal context? Our experts train our AI tools to draw out data from huge volumes of documentation, with the result that traditionally labour-intensive reviews are completed in a fraction of the time and cost. The extracted data is then checked, reviewed and analysed by human experts. And whilst we are not yet at the stage in which machines can think creatively and make their own judgment calls, there are still huge time and cost savings in using AI to augment the human review of large and complex volumes of work.

At AG we have traditionally used AI to assist in the context of due diligence reviews with impressive results. For example, we have used AI tools on a matter which required a review of over 6000 documents, covering a range of different provisions. This enabled a 71 per cent. time saving in the review of each document equating to a cost saving of over £250,000.

The Future

Traditionally, AI has been constrained by computing power (readers may be surprised to hear that the concept of AI was first posited in the 50s), but if we follow Moore's law (the idea that the speed and capability of computers can be expected to double every two years), then it stands to reason that the capabilities of AI can far exceed the position in which we find ourselves today. This is particularly so when we look at the capacity of AI to make judgement calls, and we are seeing a huge amounts of investment in this area.

But what does this mean for lawyers? It is anticipated that over the course of the next five years the pace of technology will continue to increase and new strategic choices will need to be made in the hiring strategy of law firms. Already at AG we are looking at the roles of the future to ensure that we are always remain at the cutting-edge of legal innovation, with the rights tools and people to support our clients.

We are also alive to the fact that AI is having an impact for our clients too – lenders are using AI to model credit risk and price loans, and borrowers are integrating the technology into 'smart' and eco-friendly buildings, which is particularly relevant as green and sustainable financing pushes evermore to the forefront. Such use of AI will invariable have an impact on the commercial terms of financings and we ensure that our lawyers are suitably versed and knowledgeable about how their clients are using technology to ensure that our legal application is always practical and up-to-date.

There are also challenges that both we, and our clients, need to be alive to – teaching AI on existing datasets can generate and reinforce bias; the 'decision' reached by the AI tool sits within a 'black box' and cannot be unpacked; the legal and ethical ramifications of AI have not yet been properly explored; the placement of liability can be nebulous; and AI could potentially result in competition issues.

However, the potential applications for AI, now and in the future, are endless and with collaboration between financial institutions, lawyers, tech providers and the relevant regulators challenges can be faced and overcome, as indeed they are being.

Automation – Now and in the Future

Today

Some commentators view 'automation' and 'innovation' as two distinct concepts. The differentiation primarily lies in the idea that to automate means to streamline and condense existing processes, whereas innovation strikes at something entirely new and novel. In other words, automation can be viewed as a 'sustaining' as opposed to a 'disruptive' technology.

Separating automation from innovation though is not to discredit the value of the former. The automation of both legal documents and processes can bring about great savings in time and cost.

The Future

Automation raises an interesting question of how much automation is too much automation. Will we ever get to a position in the future where the market agrees standard elections of every clause, or should we be retaining complete carte blanche when it comes to the drafting, boilerplate or otherwise?

The answer, predictably, probably lies somewhere in the middle. A balance needs to be drawn between flexibility and standardisation to ensure that we get the most out of automation but still allow us to produce tailored commercial contracts; and this was indeed the message at the recent Loan Market Association (LMA) inaugural LMA FinTech Conference. This approach may lead to a simplification of certain clauses in the future and it will be interesting to see if, in the medium to long term, drafting will take into account black-letter law, commerciality and ease of automation.

The idea of standardising certain provisions may strike readers as being out of touch with the practicalities of commercial negotiation, but in reality, typically negotiated points are actually mostly standard and well-trodden (for example, the definition of Material Adverse Effect). Therefore, it is not outside of the realms of possibility that in the future we may reach a set number of negotiated positions for certain clauses. It will also be interesting to see at what stage of a transaction the relevant optionality will be considered (e.g. will this mean that the specific drafting of certain provisions can be settled at term sheet stage?).

In the future it is likely that we will also see automation applied much more heavily to processes, as well as simply documentation. One example may be the way in which security is filed to remove the manual administrative tasks behind the filing itself. As with AI though, a change to such processes requires the collaboration of multiple parties, in this case not just lawyers but also Companies House and the Land Registry.

What next for legal technology?

This article merely scratches the surface of a world brimming with possibilities, and collaboration and coopetition with market participants will be key going forward. Nevertheless, we need to continually re-assess how we are using technology and ensure that it remains fit for purpose in our quest to quash pain-points and inefficiencies – after all, a tech tail should not wag the legal dog.

A solutions-orientated approach meshed with our industry and technological expertise is what allows us to remain on the cutting-edge of innovation and legal technology. We remain incredibly optimistic for what the future will bring.

If you would like more information on how our legal technology can support your business, please contact a member of our Innovation and Legal Technology Team.

Kerry Westland
kerry.westland@addleshawgoddard.com
0161 934 6688
07734 967 334

Clara Garfield
clara.garfield@addleshawgoddard.com
020 7788 5116
0759 1190 604

Emma Wells
emma.wells@addleshawgoddard.com
020 7160 3459
0770 9332 370

REPLACEMENT OF LIBOR WITH RFRS

Where are we in the transition process?

The replacement of inter-bank offered rates (IBORs) as one of the most widely used interest rate benchmarks is currently a work in progress, with markets expected to transition over the next few years. As part of that process, the London inter-bank offered rate (LIBOR) is expected to be phased out by the end of 2021, beyond which the Financial Conduct Authority (FCA) has said it does not intend to use its powers to maintain LIBOR.

The chosen replacement for sterling LIBOR, by the Working Group on Sterling Risk-Free Reference Rates (see more below), is a risk free rate (RFR) known as the Sterling Overnight Index Average (SONIA) and for some products in the market e.g. derivatives (where the amount of new issuances using SONIA is roughly equivalent to that for LIBOR) and fixed rate notes (where most new issuances use SONIA) the market has moved decisively towards the new rate.

Although we are aware that on the 1 July 2019 Natwest announced that it had provided the first loan priced using SONIA to National Express, generally speaking the sterling-denominated loan market (including the real estate finance (REF) loan market) is still heavily reliant on LIBOR with most new facility agreements retaining LIBOR as the basis for interest calculations, even where the term of the loan goes beyond the end of 2021. Most new facility agreements include a form of the LMA-recommended replacement of screen rate language, but this is in effect just pushing resolution of the problem further towards the 2021 deadline.

This illustrates the asymmetric approach to finding solutions across products; for example a solution for derivatives is unlikely to work for cash products.

One of the reasons that LIBOR has been retained in most new facility agreements (rather than referencing SONIA) is that many questions remain unanswered with regards to the calculation, administration and operation of SONIA by the loan market. There are a number of different concerns with referencing SONIA in facility agreements that have the potential to cause problems for lenders and borrowers, including:

- Credit risk – SONIA is a reflection of the wholesale cost of funds, whereas LIBOR can include lenders' perceived credit risk, the absence of which could result in increased margins being charged.

- Term – SONIA is an overnight rate. LIBOR is a term rate that can be used for various tenors (typically 1, 3, 6 or 12 months), which takes account of the increased risk for lending over longer periods - the absence of this from RFRs could result in increased cost.

- Backwards looking – LIBOR can be set at the beginning of a forward looking credit period, giving certainty of cash flow, whereas SONIA can only give a retrospective rate, which would not provide borrowers with certainty of cost.

In the UK, a group made up of representatives from initially the Bank of England and the Financial Conduct Authority, but now incorporating representatives from over 100 investment managers, non-financial corporates and other sterling issuers, infrastructure firms and trade associations, alongside banks and dealers (the Working Group on Sterling Risk-Free Reference Rates or RFRWG) is looking to agree a way forward for the implementation of SONIA across all product areas.

In addition, in terms of particularly developing a robust and workable SONIA rate that can be used in place of LIBOR in facility agreements (and to take the place of LIBOR in existing facility agreements) three administrators (FTSE Russell, ICE Benchmark Administration and Refinitiv) have confirmed they are working on the development of a Term SONIA Reference Rate (TSRR) and each delivered a short factual presentation to the RFRWG at its meeting on 14 May 2019. Over the remainder of 2019, the RFRWG expects administrators will work to establish if a robust TSSR, compliant with international standards, can be produced on a timetable consistent with the broader transition work and the expectation is that they will be in a position to report back later in 2019.

The Financial Stability Board published a note on 4 June 2019 on RFRs, but as part of that noted that "it considers that the greater robustness of overnight RFRs makes them a more suitable alternative than a forward-looking term RFR in the bulk of cases where an IBOR is currently used". If backwards looking rates are implemented for loans as the TSRR, this would require even more consideration of the points listed above in terms of legacy loans. Given the problems with putting together a workable TSRR however, it may be that it will be easier to proceed with the overnight rate, SONIA, in which case market participants would need to get themselves comfortable with the issues noted above.

The market would also need to agree upon a standard method for the calculation of SONIA taking into account e.g. (i) whether interest would be calculated using a simple averaging methodology, or compounded on a daily basis, (ii) whether the margin should be included on a daily basis or added at the end of the relevant term and (iii) in order to allow for calculations to be made in time for interest to be paid on each interest payment date, whether the SONIA for the relevant term would be calculated a few days before the relevant interest payment date (a) using a look-back starting an equivalent period prior to the start of the term (a "lag" mechanism) or (b) by repeating a daily rate for the last few days of a term (a "lock-out" mechanism). A fall-back mechanism in the event of the unavailability of SONIA would also need to be adopted.

What can and should borrowers and lenders be doing at this stage?

At the moment, there is a perception amongst the regulators that there has been a "wait and see" attitude until the financial services industry as a whole has more clarity on the final position as to whether SONIA or a TSRR will be adopted for loans. To that end, in September 2018, the FCA and Prudential Regulation Authority wrote to CEOs of major banks and insurers supervised in the UK asking for details of the preparations and actions they are taking to manage transition from LIBOR to alternative interest rate benchmarks including SONIA. The range of responses received was mixed, but it does seem that this has encouraged market participants to accelerate their plans to deal with the transition.

At this stage the most crucial issue for borrowers and lenders to consider is how to treat their legacy products (given the number of long-dated loans in the REF sphere, including residential mortgages this may be particularly relevant for REF lenders) taking into particular consideration:

- conduct risk implications – how can market participants making decisions know that they are doing the right thing for their borrower clients? If the transition is badly implemented, will there be a risk of claims from borrowers who believe that they have lost out?

- contractual uncertainty – if documents only refer to LIBOR with no provision for replacement rates, what will the interest rate mechanism be once LIBOR is no longer available?

- modelling risk – many models rely on LIBOR data and will need recalibration. Some market participants are already sensitising their models with the position that LIBOR will no longer be in place after 2021

- tax and accounting issues – IASB recently put out a paper covering hedge accounting focussing on what the positions will be as the transition from LIBOR approaches and the risk of LIBOR not reflecting the actual interest rate increases. Hedge accounting relief is currently expected to be in place from January 2020

Overall therefore, while it seems that currently there is little that can be done in terms of documenting loans to reflect the position after the LIBOR transition (beyond ensuring that the LMA Replacement of Screen Rate language (or equivalent) is included when new facility agreements are entered into (and ideally when amending and/or restating existing facility agreements)) borrowers and lenders should both look to consider their existing loans and what (if anything) needs to be done with them.

Please do not hesitate to contact us if you have any questions around the impact of the LIBOR transition on your loan book and if there is anything that we can do to assist with your management of LIBOR transition.

Sarah Egbu
sarah.egbu@addleshawgoddard.com
020 7160 3271
0780 3249 912

Neil McGibbon
neil.mcgibbon@addleshawgoddard.com
020 7160 3337
0771 2508 029

THE EVOLVING SCOPE OF SUSTAINABLE FINANCING

In our last edition of this publication 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 lenders and borrowers in the real estate finance (REF) market.

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 REF loan context, this may include not only taking account of a building's CO2 emissions but also the working conditions for employees within the building and the corporate governance issues of the landlords who own, or the tenants who occupy, the building.

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 a new build that meets regional, national or internationally recognised standards or certifications). 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, energy performance certification and/or certification that an agreed annual amount has been invested into achieving energy efficiency) 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 image and business development opportunities. Sustainability linked loans naturally open up the door to these evolving new loan products to a much wider group of REF 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 likely 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 (for example, similar to a lender appointed project monitor in a development context). 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 REF 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 and 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 or, if you are considering the value of the underlying business of a tenant, its corporate governance or public image, could have a significant impact on that value).

How can REF 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.

Zak Ikponmwosa
zak.ikponmwosa@addleshawgoddard.com
020 7160 3026
0778 4294 603

Zoe Maurer
zoe.maurer@addleshawgoddard.com
020 7160 3144
0773 8023 105

Ian Kynoch
ian.kynoch@addleshawgoddard.com
020 7160 3253
0772 5732 066

REAL ESTATE FINANCE TEAM – SENIOR CONTACTS

London

STEVE MACKIE
Partner – Head of Real Estate Finance

07921 417 457
020 7160 3269

SARAH EGBU
Partner

07803 249 912
020 7160 3271

ZAK IKPONMWOSA
Partner

07784 294 603
020 7160 3026

ZOE MAURER
Partner

07738 023 105
020 7160 3144

JAMES SALFORD
Partner

07801 496 128
020 7160 3490

PAUL SALSBURY
Partner

07887 997 566
020 7160 3164

NEIL MCGIBBON
Legal Director

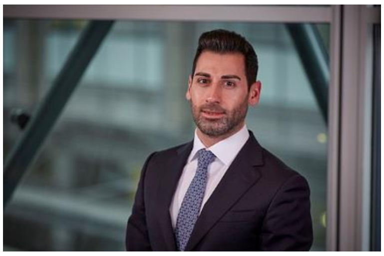
07712 508 029
020 7160 3337

IAN KYNOCH
Managing Associate

07725 732 066
020 7160 3253

ARA VADJARAGANIAN
Managing Associate

020 7788 5092
07979 668 688



ANDREW WHITTAKER
Managing Associate

07802 338 174
020 7160 3250

Manchester

MARTIN O'SHEA
Partner

07775 586 372
0161 934 6403

KATIE RIDEHALGH
Partner

07775 586 428
0161 934 6671

RICHARD CHANDLER
Legal Director

07738 144 072
0161 934 6352

CAROLINE GRAY
Legal Director

07841 080 565
0161 934 6695

Leeds

ANDREW FORDHAM
Partner

07545 935 684
0113 209 2613

DAVID HANDY
Partner

07720 350 326
0113 209 2432

JENNY CROMACK
Consultant

07714 848 782
0113 209 2430

LOUISE WOOD
Managing Associate

07872 675 154
0113 209 7576

Scotland

NEIL ADDIS
Partner

07767 268 242
0131 222 9589

TOM SPEIRS
Partner

07918 630 938
0131 222 9809

ADDI SPIERS
Partner

07501 228 738
0131 222 9498

JOHN WALLER
Legal Director

07562 950 415
0131 222 9524

EUAN ANDERSON
Managing Associate

0131 222 9451

addleshawgoddard.com

Aberdeen, Doha, Dubai, Edinburgh, Glasgow, Hamburg, Hong Kong,
Leeds, London, Manchester, Muscat, Singapore and Tokyo*

*a formal alliance with Hashidate Law Office