ARTHUR COX

Group Briefing

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Sustainable loans are here to stay

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Ireland M&A Legal Adviser of the Year 2018
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Ireland Client Service Law Firm of the Year 2018
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Ireland Law Firm of the Year 2018
International Financial Law Review (IFLR) Europe Awards

Advised on Equity Deal of the Year 2018 – Allied Irish Banks IPO
International Financial Law Review (IFLR) Europe Awards

Ireland Law Firm of the Year 2018
Who's Who Legal

Ireland Law Firm of the Year 2017
Chambers Europe Awards

Best Firm in Ireland 2018, 2017 & 2016
Europe Women in Business Law Awards

Best National Firm for Women in Business Law 2018, 2017 & 2016
Europe Women in Business Law Awards

Best National Firm Mentoring Programme 2018, 2017 & 2016
Europe Women in Business Law Awards

Best National Firm for Minority Women Lawyers 2018
Europe Women in Business Law Awards

Sustainable loans are bilateral or syndicated credit facilities where the terms of the financing offer the borrower some form of incentive to achieve targets for improving their environmental, social and governance (**ESG**) or sustainability performance.

INTRODUCTION

There have been various positive developments relating to green finance over the past few years: for example, Ireland is one of several sovereigns to have issued a green bond in line with the International Capital Market Association Green Bond Principles and numerous corporate borrowers have entered into loan financing transactions which comply with the green loan principles published by the Loan Market Association and other trade associations (the Green Loan Principles). However, recent Bloomberg data has shown that the issuance of '*sustainability-linked*' or '*ESG-linked*' loans (referred to in this briefing as sustainable loans) outstripped that of green loans in 2018.

The performance incentive element to sustainable loans is usually achieved by means of a margin ratchet which adjusts the loan's pricing by reference to one or more performance measures selected by the parties (as an alternative to a margin ratchet tracking performance against financial covenants). The amount of any margin adjustment may not be particularly significant, particularly for an investment grade borrower which is likely to benefit from attractive pricing and/or may be entering a revolving credit facility which is unlikely to be fully drawn at all times.

However, this incentive-based approach is aimed primarily at demonstrating the commitment of all parties to a loan financing to achieving (and financing) sustainable business performance rather than minimising pricing. The relevant sustainability performance targets may be selected because they are particularly relevant to the borrower company's core business or may instead track a basket of factors by way of the use of an ESG rating or score determined by an external consultant or advisor.

Sustainable loans potentially offer greater flexibility and wider scope for application for borrowers whose activities are outside of the core '*green financing*' space. For example, the Green Loan Principles currently require compliance with requirements for Use of Proceeds, Process for Project Evaluation and Selection, Management of Proceeds and Reporting. These requirements may not be workable for all transactions (given a borrower may not raising debt solely to fund specific green projects) or for all types of financing (it may be difficult to limit the use of a revolving facility to green purposes only rather than general corporate purposes) although the Green Loan Principles may be able to accommodate this issue by allowing for a '*green loan*' tranche within a larger revolving facility.

EXAMPLES OF SUSTAINABLE LOAN TRANSACTIONS INVOLVING BUSINESS-SPECIFIC ESG TARGETS OR EXTERNAL ESG MONITORING

» Italian insurance company **Assicurazioni Generali** has raised revolving facilities which link pricing to progress made in relation to certain sustainability initiatives.

» **Red Eléctrica de España** (Spanish electricity network) entered into a EUR800m RCF with a margin ratchet linked to a ESG rating assigned by the independent provider Vigeo Eiris.

» **Pennon Group** and its subsidiary **South West Water** have entered into revolving credit facilities with margin ratchets which are based on performance indicators linked both to their overall ESG performance and to specific targets for bathing water quality in the region supplied by South West Water.

SUSTAINABILITY LINKED LOAN PRINCIPLES

The Loan Market Association, the Loan Syndications and Trading Association and the Asia-Pacific Loan Market Association on 20 March 2019 published the Sustainability Linked Loan Principles ("**SLLP**") to "*promote the development and preserve the integrity*" of sustainable loans by providing guidelines which capture the fundamental characteristics of these loan products. The SLLP set out four key components which should be addressed in a sustainable loan financing:

» **Relationship to a Borrower's Overall Corporate Social Responsibility (CSR) Strategy**

Each borrower should clearly communicate to its lenders its sustainability objectives and how these align with the sustainability performance targets proposed to be used in its sustainable loan financing, as well as providing details of any external standards or certifications to which they are seeking to conform.

» **Target Setting – Measuring the Sustainability of the Borrower**

"*Performance targets should be ambitious and meaningful to the borrower's business and should be tied to a sustainability improvement in relation to a predetermined performance target benchmark*".

Borrowers may be encouraged to seek a third party opinion as to the appropriateness of their sustainability performance target as a condition precedent or otherwise borrowers should seek to demonstrate or develop the internal expertise to verify its approach.

» **Reporting**

Borrowers should be encouraged to report information relating to their sustainability performance targets either in public reporting or in private reporting delivered to its lenders.

» **Review**

For publicly traded companies, it may be sufficient for lenders to rely on the borrower's public disclosures (accompanied by appropriate audit/assurance statements) to verify its performance against its sustainability performance targets. In other cases, a borrower's performance should be independently verified by a qualified external reviewer, such as an auditor, environmental consultant and/or independent ratings agency, at least once a year.

INCENTIVE FOR LENDERS TO PARTICIPATE

Regulators are increasingly focussed on sustainable finance: recent legislative proposals published by the European Commission in this area have been aimed at (among other matters) ensuring that financial institutions have adequate systems and controls to manage the risks arising from climate change (including to their own business models) and that they support the transition to a low-carbon economy. There has also been some speculation as to whether future capital regulatory frameworks may potential offer preferential capital treatment for assets which comply with certain sustainability metrics.

Participation in sustainable loans is a means for banks to demonstrate their efforts in this area and also to highlight their performance against their own ESG goals. For example, BNP Paribas has stated that it aims to ensure that at least 40% of its loan assets are subject to specific systems to manage environmental/social risks. Establishing credentials in sustainable loans is also of course a means for banks to show their alignment with their corporate customers' ESG objectives.

As the sustainable finance market develops, banks which originate sustainable loans may face conflicting dynamics in relation to syndication and balance sheet management, as they may see incentives both to retain ownership of sustainable loan assets (in line with their own ESG goals) and also to sell down their exposure in order to tap into the growing institutional investor demand for sustainable finance assets. This is unlikely to be a pressing concern for as long as revolving facilities for investment grade corporate borrowers dominate the sustainable loan market but may become more relevant as drawn term loans and private placements become more common types of sustainable loan financings.

KEY CONTACTS

MATTHEW DUNN
PARTNER, HEAD OF PROJECT AND INFRASTRUCTURE FINANCE
+353 1 920 2020
matt.dunn@arthurcox.com

GRAINNE HENNESSY
PARTNER, FINANCE
+353 1 920 1202
grainne.hennessy@arthurcox.com

BRENDAN WALLACE
SENIOR ASSOCIATE, DEBT CAPITAL MARKETS
+353 1 920 1069
brendan.wallace@arthurcox.com

CHARLOTTE UPTON
SENIOR ASSOCIATE, PROJECT FINANCE
+353 1 920 1113
charlotte.upton@arthurcox.com