Raising sustainability awareness in the loan market

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These days, you get to pick your poison: climate crisis, air pollution, carcinogenic food, accumulation of ocean garbage. There are also the alarming findings of The World Wide Fund for Nature's "Living Planet Report 2018: Aiming Higher", which flagged that the population size of wildlife decreased by 60% globally between 1970 and 2014, with the decline of more than 4,000 mammal, bird, fish, reptile and amphibian species. "Earth is losing biodiversity at a rate seen only during mass extinctions," the report warned.

While environmental and social themes are creeping into the world of business, bringing with them new constraints – think monitoring of CO2 emissions – as well as opportunities beyond renewable energy, the question arises as to how the loan market is looking to contribute.

The cradle of loan market innovation in sustainable finance is set within the EMEA region. A recent Loanly Planet article, an LPC publication, cited the EMEA region as representing 70% of the total global green loan and sustainability linked loan volumes for the year-to-date (as of May 2019), with total global volumes amounting to over US$39 bn.

We predict that this is just the beginning, and more questions will be asked, more resources dedicated, and eventually greater strides taken by loan market participants worldwide.

Green loans: expanding further the path opened by green bonds

Green bonds and green loans might be described as the Batman and Robin of the green finance world. With the same intended purpose, the latter have the benefit of the bespoke loan market flexibility, in size and customisation. Having a ten-year head start and predicted at U$200 bn issuance for 2019 (source: Moody's report dated 31 January 2019), green bond volumes have, however, vastly outpaced green loans so far.

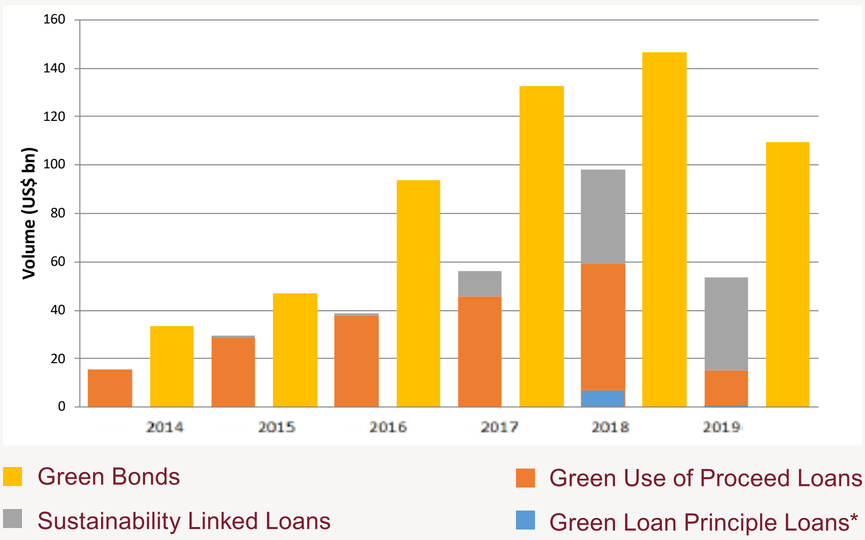
As with green bonds, green loans are intended to finance or support activities qualifying as "green". The word "green" is used as a defined term in the capital markets in reference to the "Green Bond Principles" (GBP), published by the International Capital Market Association in January 2014, and the "Green Loan Principles" (GLP), published by the LMA and APLMA in March 2018. The GLP's definition of use of proceeds that qualify as "green" is aligned to the definition in the 2017-version of the GBP and any subsequent updates. The GLP list ten eligible uses[1]. With this, the contour of these authorised uses of proceeds has become clear and the market has developed an understanding of what is definitely green, what definitely is not, and what is debatable. Publishing a green framework allows a borrower to issue green bonds and green loans under the same parameters.

An example of the flexibility afforded by green loans is the possibility of financing pure-play companies such as Sustainable Power Group LLC, a solar and wind power developer, which issued a US$175 mn green loan revolving credit facility (RCF) in March 2018, the first green loan in the Americas. Similarly, the first breakthrough in the leveraged loan market was the Proxiserve transaction, which was allocated in February 2019. The total €395 mn debt package included a €335 mn term loan B and a €60 mn tranche, which was the first, albeit partial, green revolving credit facility in the French leveraged buyout market. Following the company's buyout by Mirova, via their infrastructure arm, Asterion, and Proxiserve's management, the company dedicated its Green Capex RCF to activities resulting in better energy and water consumption efficiency. A loan with such uses of proceeds can be made at more attractive costs for the borrower.

Many other forms of loan financing beyond green loans support environmental considerations. These include renewable power project financings and mass transportation infrastructure financings.

While some of these are structured around the GLP, most are not yet. To capture this gap, Bloomberg tracks both GLP compliant green loans, as well as other loans, that might not match the four pillars of the GLP (being, Use of Proceeds, Process for Project Evaluation and Selection, Management of Proceeds, and Reporting), but nevertheless support "green" activities. This wider universe is being picked up via Bloomberg's "Green Use of Proceeds" criteria. See Figure 1 below.

Figure 1. Chart date: 26/06/2019



Source: Bloomberg

*Part of Green UoP Loans

1. See Appendix 1 of the GLP

The Green Loan Principles and Sustainability Linked Loan Principles: bringing unity

Just as the fight for environmental preservation and social progression needs global endeavour, the LMA, APLMA and LSTA all formed a united front in 2018. This commendable worldwide cooperation resulted in a coordinated amendment to the GLP in December 2018. The LMA, APLMA and LSTA have helped greatly in promoting the legitimacy of these new loan products, particularly in markets lagging behind, and will continue to do so. The GLP are a great point of reference in discussions with borrowers, among lenders, as well as with lawyers and other service providers. They provide a common ground, upholding standards and setting boundaries.

In a continuation of their global efforts, the three loan market associations also produced the "Sustainability Linked Loan Principles" (SLLP) in March 2019, in support of another loan market innovation that first appeared five years ago and only really emerged in the past 18 months.

Sustainability linked loans: the scenic route

Instead of focusing on the use of proceeds of the loans, sustainability linked loans look to demonstrate that a borrower has started a transition towards a low carbon economy, or is looking to improve its position vis-a-vis other environmental or social issues. The borrower, in discussion with its lenders, decides on its strategic priorities for improvement. Based on such priorities, related key performance indicators (KPIs) are selected. They can be measured either internally, via the borrower's own resources, or externally, via third party monitoring. In turn, the lenders offer additional carrot and stick effects via a sustainability linked discount and premium applied to the margin.

Sustainability linked loans are positioning themselves as a key evolution in the loan market by inserting the environmental, social and governance (ESG) strategy into the borrower/lender relationship. With successive industries seeing the launch of sustainability linked loans, precedents are set on a daily basis.

We have already seen a large sample of KPIs being used. The following is a non-exhaustive menu of possible themes: reduction of CO2 and greenhouse gas emissions, installation of new renewable power sources, increased use of hybrid and electric vehicles in a fleet, energy savings, sustainable agronomic practices, responsible food sourcing, waste and packaging reduction, green constructions, green investments, healthy eating, diversity, labour conditions, workplace safety, quality of life, access to housing, and overall ESG scores.

Loan pricing in the context of environmental and social impact

A sustainability linked loan is initially priced in the same way as any other loan, according to loan market dynamics, with an additional discount or premium applicable to the pricing of the loan, triggered by KPIs being met or not. A huge range of possibilities is available to borrowers and lenders for setting these KPIs, and the discount and premium magnitude should not be one-size-fits-all.

The margin reduction granted for meeting KPIs is intended to incentivise and reward the borrower's efforts. The margin increase for not meeting KPIs is intended to have the opposite effect, and is also intended to provide for consistency, accountability and reciprocity.

In relation to the new sustainability linked loans, the first compliance certificate reporting actual KPI results is requested up to a year after the sustainability linked loan is put in place. We have already seen cases of the implementation of decreases in pricing, stable pricing and even increases in pricing. In the case of margin increase, the question arises as to whether such trigger was a reflection of insufficient efforts from the borrower to meet its target, or whether – rather than being a disappointment – such instances could be interpreted as proof that the borrower had selected genuinely ambitious KPIs. The latter would be a respectable approach. It would also demonstrate that the sustainability link is working as intended.

The credit impact, and more directly, the actual environmental and social contribution of the measured results, should ideally be taken into account in determining the magnitude of the pricing adjustment. And this is where the fun begins! What is the impact? Will the loan, through its set KPIs, make a difference? As Michael Wilkins, Managing Director and Head of Sustainable Finance at S&P Global Ratings, highlights: "Who knows if the company has set itself easy or tough targets and how much achieving such will contribute?" Michael Wilkins contrasted his statement with the fact that the green loan and green bond markets benefit from Principles that help with the systematisation of frameworks around the use of proceeds. In the sustainability linked loan market, despite and beyond the issuance of the SLLP in March 2019, many market precedents and industry standards still remain to materialise, due to the customisable and flexible nature of the sustainability linked loan. Perhaps through experience and product maturity, the proposals will continue to gain in thoughtfulness, thoroughness and impact.

Banks are developing their sustainable banking teams, with ESG specialists participating in their credit committees, a sign that they are starting to tie together credit risk and ESG criteria.

Similarly, in the leveraged market, institutional investors are also incorporating ESG factors into their credit decisions. Fiona Hagdrup, Leveraged Finance Fund Manager at M&G Investments, explains: "ESG considerations, while always implicit in our credit analysis, have become more explicit over the last six years."

Help needed from the loan market services industry

Many loan market data providers, rating agencies, second opinion providers and news reporters are also picking up on these loan market innovations. They are supporting the work of issuers, arrangers

Figure 2.

and investors by using their analysis and research, which is channelled through new support products.

With its proposed Carbon Transition Assessment tool, for example, Moody's is looking to grasp what ESG issues are the most relevant for creditors. In particular, as Rahul Ghosh, Senior Vice President in the Assessments Group of Moody's Investors Service, summarises: "Market practitioners not only want to evaluate the impact of the company on the environment, but also the impact of the material environmental trends on the company today, as well as in the future."

Mapping industry reference points is key to helping loan market participants gain expertise and fluency in relation to the materiality of the selected KPIs and use of proceeds.

Why should the loan market bother?

Is integrating these considerations worthwhile for loan market players, mainly for the issuers, but also investors, arrangers and service providers?

While the motives are all intertwined (See Figure 2), we can put together the short term and obvious benefits to a company or financial institution, including cost savings (by saving energy, sourcing cheaper financings) and immediate business opportunities. Risk mitigation (for example, hedging potential issues before they boomerang back) could encompass the prevention of catastrophic events like Dieselgate and the Macondo well disaster, as well as statistics around the financial performance of ESG-savvy companies. There is also the notion that stakeholders care enough for the company to decide to communicate on its positive actions (for positive branding or to safeguard their reputation) or decide to keep up with the Joneses or even outdo the competition. Finally, board-level strategic vision and significant shifts in business models look to capture growing concerns from shareholders, consumers and employees.

The reasons that come back from borrowers who are not interested in a green loan or sustainability linked loan fall mostly within the first of the following three themes.

Borrowers have noted the perceived limited economic benefit, time commitment uncertainty, in particular regarding legal documentation and reporting, uncharted cost implications, as well as a lack of teams and resources for KPI monitoring. Headwinds also include uncertainty over which KPIs to set and the relevant levels. Some borrowers have mentioned that they think that they are too "brown" to look green and are afraid of risking a "green washing" backlash. Finally, some companies are of the view that they do not need to go to the loan market with a green loan or sustainability linked loan to prove how relevant a player they already are in sustainability; in short, they might not see how this loan feature adds value.

We expect that some of these issues will clear up as knowledge of these new loan products expands. A further upturn will require loan market players to dedicate more time and resources. In particular, keeping a close watch on the targeted and realised impacts via scientific evidence will be key to growing further the legitimacy of these innovative products.

Finally, could our environment and social responsibility become increasingly accepted as a business value, or should the expression of each individual's level and form of engagement remain personal? Alternatively, since the current economy appears inefficient at capturing externalities on the environment, our health and security, should banks and corporations take on the responsibility of leading the change? Or should policy makers intervene?

We might already be experiencing a paradigm shift. Genuine and authentic efforts that result in increased awareness are laudable and should be closely entertained for their contribution, however modest that might be.

Market drivers and distribution

About fifteen banks are already leading the charge in the development of green loans and sustainability linked loans. These banks are competing for mandates and roles such as Green Loan Structuring Agent, Green Loan Agent, ESG Coordinator, or Sustainability Coordinator – the market has not settled on final terminology for these titles yet. Another ten-plus banks are ramping up their knowledge and internal resources. Their interest and support are triggered by the publication of the GLP and the SLLP, the transactions they are involved in, as well as client enquiries. The number of institutions in the bank market that have already taken a piece of a green loan or a sustainability linked loan is estimated at about 100, and growing. Nonetheless, uneven awareness levels can be found, not only across, but also within, each single financial institution. The GLP and the SLLP should be great resources for such institutions and their employees.

It should be noted that the discussions held with borrowers in the context of sustainability linked loans might help banks pre-empt pressure from the regulators, which may ask them in the future to better integrate ESG in their credit model.

Be ambitious

With the goal of using the loan market to support and highlight sustainability causes, should come the will to go the extra mile at all levels of the loan market chain. Materiality, transparency and expertise will ensure the continuity of these new products by making changes visible and mitigating potential reputational risk. We can all keep exploring together, raising awareness of the magnitude and repercussions of the environmental and social issues, and spurring the loan market into authentic and meaningful action. The LMA, with its crucial role in the loan market, will continue to play a significant part in fostering increased awareness.