SUSTAINABLE FINANCE AND SHIPPING

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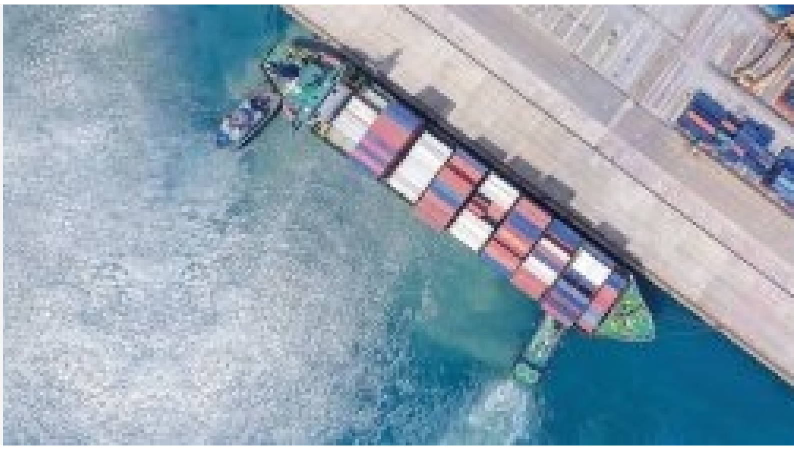

International shipping accounted for around 2% of global energy-related CO2 emissions in 2019. While shipping is the most energy efficient way to carry cargo, the transportation industry in general, and shipping in particular, has not historically kept the pace with some other industries in terms of decarbonisation. Combined with increasing cargo volumes, the result is that shipping related CO2 emissions have in fact increased since the year 2000, not decreased.

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Pressure is, therefore, mounting on ways to tackle this decarbonisation challenge. This comes from a range of sources, such as the Paris Agreement, regulators like the IMO, financial institutions courtesy of the Poseidon Principles, the world's largest cargo owners through the Sea Cargo Charter launched in October 2020, and companies' own Scope 3 emission targets which impact their entire supply chain. Additional complexity arises from the need for industry-wide cooperation in its approach, with companies fearing short-term competitive disadvantage if they are the sole movers in the industry. These external pressures will be covered in more detail in our upcoming Scope 3 emissions article, but these factors, juxtaposed again with the current state of the industry in terms of CO2 emissions, provide the context for why the calls for change in the industry continue to grow louder.

THE GLPS AND SLLPS

As discussed in our previous article on this topic, the wider financial market has developed tools specifically to help tackle the decarbonisation challenge. The Green Bond Principles ("GBPs") were first published by the International Capital Markets Association ("ICMA") in 2014 and were followed by the Green Loan Principles ("GLPs") (developed by a working party of leading financial institutions under the auspices of the Loan Market Association, the Asia Pacific Loan Market Association, the Loan Syndications and Trading Association and the ICMA) in 2018. Both the GBPs and GLPs provide recognised market standards and share the aim of facilitating and supporting environmentally sustainable economic activity.

The four core components of the GLPs are:

(i) a green use of proceeds;

(ii) communicating the sustainability objectives and the selection of green projects to its lender(s);

(iii) management of proceeds in dedicated accounts; and

(iv) detailed reporting requirements to its lender(s).

While the introduction of these principles was undoubtedly a positive first step, arising out of the ‘use of proceeds’ requirement in which loan proceeds must be used for specific sustainable projects, they have not been inclusive enough to attract the wider green market.

"The Sustainability Linked Loan Principles... and the Sustainability-Linked Bond Principles... [open] the door to a wider pool of borrowers."

The Sustainability Linked Loan Principles (“SLLPs”) published in March 2019, and the Sustainability-Linked Bond Principles, published in June 2020, by contrast, are linked to the overall sustainability profile of the borrower by measuring the latter’s performance against pre-determined sustainability performance targets (“SPTs”). This approach opens the door to a wider pool of borrowers. [*Margin quote to be: “The Sustainability Linked Loan Principles… and the Sustainability-Linked Bond Principles…[open] the door to a wider pool of borrowers*.”]

The core components of the SLLPs are:

(i) the borrower must communicate how their sustainability objectives (as set out in their CSR strategy) align with the proposed SPTs;

(ii) the borrower and lender(s) must negotiate and set ambitious and meaningful SPTs, tied to sustainable improvement, which the borrower’s performance is measured against, and the terms of the loan are tied to;

(iii) the borrower must make and keep information relating to their SPTs readily available (given the financial consequences of meeting, or not meeting, the SPTs); and

(iv) a review and verification process of whether or not the borrower is in compliance with the SPTs.

On the surface, both the GLPs and SLLPs place additional burdens on a borrower compared to a vanilla corporate financing, yet the volume of both continues to rise. The primary reasons for this are that the amount of sustainable and green lending available is increasing (attributable to a combination of improving economic fundamentals, a high growth market, and reputational reasons), which has resulted in more available green finance. From the borrower’s perspective, two main advantages exist. The first is that cheaper debt may be available, both as a result of the introduction of this increased liquidity and the nature of the GLPs and SLLPs themselves; for example, the SLLPs can offer a margin reduction mechanism if the SPTs have been met. The second is that these funds are being used for green or sustainable operations, which in the medium to long term will improve the sustainability profile of the borrower and better prepare them for the body of regulations implemented and being implemented on, in the context of this article, the maritime industry worldwide.

In November 2020, the Climate Bonds Initiative ("CBI") – an investor-focussed not-for-profit organisation overseen by the Climate Bonds Standard Board – issued the *Shipping Criteria* of its International Climate Bond Standard, which established a best practice for low carbon and climate resilient investments in the shipping sector. CBI summarises these criteria as follows:

- ships cannot be primarily dedicated to transporting fossil fuels; and
- ships must either be:

  – specified to be zero-carbon from the year the bond is issued or must demonstrate that the expected carbon equivalent intensity of the ship is aligned with the decarbonisation trajectory (emissions intensity threshold) of the ship's type/size category over the lifetime of the bond, reaching zero emissions by 2050; or

  – ships that are not zero-emissions must provide a managed plan that shows how the ship can remain under the emissions intensity threshold during the operational life of the ship.

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Despite some clarification being established by the CBI, there has been much debate around sustainable finance and 'green washing' – with the shipping industry coming under particular scrutiny. The closing in January 2021 of the consultation period relating to the EU Taxonomy on sustainable finance means that investors and shipping companies will have some certainty in determining whether certain economic activities will be classified as being sustainable in climate terms.

FINANCING OPTIONS

The maritime sector has historically benefitted from a wide selection of financing options, ranging from:

- Traditional – secured debt financing;
- Tax-based leasing – utilisation of tax-based leasing structures such as Japanese tax leases (JOLCOs), French and Spanish tax leases;
- Leasing generally – of increasing significance in recent years, specifically but not only with Chinese lessors;
- Structured – as part of freight capacity procurement, debt can be made available to tonnage providers which is then used to service and repay the debt;
- Corporate – the energy majors and commodity traders, and other 'A-list' companies, have an unparalleled ability to borrow off balance sheet; and
- Project/Receivables – with longer term freight capacity secured, debt can be lent against charter revenues.

As indicated by the growth in CO2 emissions in the shipping industry since 2000, the adoption of green or sustainable loans has, however, not been widespread in the ship finance world. This is despite being a market that is well suited to these products.

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For green loans which require a 'use of proceeds' this is relatively straightforward and can be used towards an LNG-fuelled vessel or tranches of a facility being applied for specific green uses, such as (historically) scrubbers or ballast water treatment systems.

Sustainable loans on the other hand provide the greatest flexibility but are also the least well understood. Below are some factors that can be incorporated into, and used as a basis for, sustainability-linked financing in the maritime sector.

Related to Business Strategy:

The creation of medium- and long-term decarbonisation plans (aligned with/measured against IMO emission standards and targets).

Related to Climate/Targets:

- Setting targets, which can be measured empirically, and confirming achievements each year (e.g. Environmental Ship Index or Fleet Sustainability Scores – related to Scope 1, 1+2, rate of CO_2 emissions reduction (by scope, country, and business segments)); and
- Targets of ratio percentage for research and development expenditure on green maritime technologies related to low carbon efforts.

Related to sustainable fuel types:

Plans to adopt LNG or other low-emission fuelled engines.

Related to technology:

Plans to invest in and adopt emission reducing design and technology.

The creation of sustainability performance targets is best thought of as part art and part science. They must be ambitious and meaningful and tied to sustainable improvement; and while certain parameters do exist, there is also great flexibility in developing these. Despite some uptake, in the shipping industry has generally not yet exploited this to its full potential.

We hope that through this forthcoming series of articles, by highlighting some of the options available within the green and sustainable loan market, will help stimulate new conversations around sustainability and shipping, from financing to operations.

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