GREEN AND SUSTAINABLE LOANS: A SHORT EXPLAINER

8 FEBRUARY 2022 • ARTICLE

INTRODUCTION

The loan markets have responded to the rise in ESG investment – investment focussed on or mindful of Environmental, Social and Governance criteria – by setting out certain principles for participants to engage with the Sustainability Linked Loan Principles (the "SLLP") and the Green Loan Principles (the "GLP"). Whilst both these products might fall under ESG as an umbrella term, it's worth bearing in mind that they are different products.

The GLPs and the SLLPs were released by the LMA, APLMA and LTSA in 2018 and 2019 respectively. As the products have developed, subsequent guidance highlighting the potential applications of the GLPs in the context of real estate finance was issued in 2020. More recently with the rapid rise in the number of sustainability linked loans, the LMA, APLMA and LTSA have taken time to reflect on the increase and have published an update to the SLLPs (see below).

ANALYSIS

There is currently no standard form documentation for either green loans or sustainability linked loans. Whilst each of the GLPs and the SLLPS make suggestions on where focus should be paid, the absence of any market standard document allows the parties to decide if a loan is consistent with the GLPs or SLLPs. The lack of a market standard form may slow down the adoption of these types of loans.

Both the GLPs and SLLPs warn of the issue of "green / sustainability washing" where a loan's green or sustainability features are exaggerated. The concern here being that such practices will undermine the value of those truly green or sustainability linked loans.

Though, in many respects, at least within Europe the introduction of Regulation (EU) 2020/852 of the European Parliament and EU Council which came into force on 12 July 2020 (the "Taxonomy Regulation")[1] is intended to clamp down on so called "greenwashing".

Whether investors obtain green loans to carry out a green project or a sustainability linked loan to improve their credentials, the incentives are now more than simply pricing in the financing product and are far more long term.

Many borrowers and sponsors have had an awareness of ESG, but it has not been a central focus and has often been relegated to the CSR office as something to include in marketing publications[2]. But this is beginning to change. In a recent research report prepared by MSCI ESG Research LLC[3] the authors noted that research indicated that companies with better-managed ESG risks tended to enjoy lower costs of capital suggesting that the market saw them as less risky.

ESG investment in an efficient or green building for example can allow owners/investors to command a premium, often referred to as the Green Premium[4], resulting in higher rents or asset premiums on sale.

> "A green loan is any type of loan made for the purposes of financing a 'green project'."

But what happens if owners/investors don't invest in sustainable improvements / buildings. Are they likely to suffer a brown discount and what would that look like? The theory around the brown discount relates to the fact that the value of any commercial real estate is driven by the present value of the future cashflows, i.e. the rental income[5] less costs. Anything impacting on the value of those future cashflows will impact on the value of the building as a whole.

As 'brown' buildings face increasing maintenance costs and delayed capital investment to meet stricter building requirements, they also face reduced demand from premium tenants looking to improve their green profile and regular tenants who shun the variable and higher utility costs. The building owners therefore have to reduce their rents to entice tenants[6] which leads to a reduction in the value of the asset as a whole.

The use of green loans and sustainably linked loans can help real estate investors with long term horizons achieve their objectives sustainably.

WHAT IS A GREEN LOAN?

A green loan is any type of loan made for the purposes of financing a 'green project'. The definition of 'green project' is deliberately wide and includes, but is not limited to, projects focussed on renewable energy, energy efficiency, pollution prevention and control, sustainable management of natural resources, biodiversity conversation, sustainable water management, clean transport, or building green buildings.

Whatever the green project, the central tenet is that there must be a clear environmental benefit. The GLPs provide a framework of four central components:

1. **Use of Proceeds**

The proceeds of a green loan must be applied towards a green project as referred to above. In the context of real estate, an example would be for the proceeds to be applied to build an environmentally friendly building.

2. **Process for Project Evaluation and Selection**

Borrowers must communicate their sustainability objectives to their lenders and show how the green project aligns with such a strategy.

3. **Management of proceeds**

The proceeds of a green loan should be credited to a dedicated bank account or otherwise tracked by the borrower so as to maintain transparency and promote the integrity of the green loan. As part of maintaining transparency, borrowers are encouraged to establish an internal governance process to track the proceeds of a green loan.

4. **Reporting**

Borrowers are required to provide updates at least annually to their lenders on the use of the proceeds of a green loan. The reporting should use both qualitative and quantitative metrics.

WHAT ARE SUSTAINABLY LINKED LOAN PRINCIPLES?

In contrast to green loans as discussed above, the use of proceeds is not the distinguishing feature. A sustainability linked loan incentivises a borrower to improve their sustainability profile over the term of the loan. Borrowers enjoy a reduced margin for achieving pre-agreed ESG-related KPIs.

In March 2019, the LMA, APLMA and LTSA launched the SLLPs with an accompanying guidance note. This provided a framework for sustainability linked loans and was designed to promote the development and integrity of the product. They are based around the following core components:

- Selection of KPIs;
- Calibration of sustainability performance targets;
- Loan characteristics;
- Reporting; and
- Verification.

In May 2021, the LMA, APLMA and LTSA issued updated guidance refining and tightening the core components and aligning them with the International Capital Market Association’s sustainability linked bond principles.

If you would like to discuss any of the above or the implications in the context of real estate finance transactions, please contact Richard Hughes or Alexander Collis.

[1] For more information on the Taxonomy Regulation please see WFW article linked here.

[2] Lee, L.E. Thwing-Eastman, M & Marshall, R. (January 2020). 2020 ESG Trends to Watch. (MSCI ESG Research LLC).

[3] Lee, L.E. Thwing-Eastman, M & Marshall, R. (January 2020). 2020 ESG Trends to Watch. (MSCI ESG Research LLC).

[4] Savills. May 2021. Is there a Green Premium for new homes?

[5] Leskinen, N. Vimpari, J. Junnila, S. (31 March 2020) A Review of the Impact of Green Building Certification on the Cash Flows and Value of Commercial Properties. MDPI

[6] As something of a contraindication it's difficult to quantify the value of the green premium and there is still debate surrounding it, in a recent report considering the effect of the green premium in the housing market, the authors noted that whilst many purchasers considered green issues to be important, few were willing to pay more for a more efficient house. The same is likely true of commercial entities. Financial drivers are still important. Though arguably this is likely a short term view.

KEY CONTACTS

RICHARD HUGHES
PARTNER • LONDON

T: +44 20 7814 8154

rhughes@wfw.com