GET INTO THE GREEN SCENE: SUSTAINABILITY LINKED FINANCE IN AIRCRAFT FINANCE

4 OCTOBER 2022 ● ARTICLE

The aviation industry is taking its responsibility to achieve net zero seriously through self-led strategies. Historically, carbon reduction has been driven by new airframe and engine technology developed to reduce fuel burn, though principally to reduce operating cost as well as carbon. The industry otherwise tended to defer to governments and supra national organisations for big picture macro strategies to manage aviation's impact on climate change. This approach, carbon trading for example, had limited success due to the requirement for widespread international cooperation which was not forthcoming. With other efforts to be more "green" having equal limited success, such as carbon offsetting options for passengers when purchasing a ticket, a scheme introduced by some airlines, it was clear over time that the industry had to more, and had to do better.

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Fast forward to the present and now all industry participants, from manufacturers to leasing companies, from energy producers to MROs, are mining new technologies and processes to produce radical plans to reach net zero. These new strategies range from electric engines to feed stock fuel and beyond, all while continuing to push the envelope on developing more efficient airframe and engine technologies.

The global finance industry also recognised it could, and needed to, play a significant role in reaching net zero. Its focus has typically been through financing green assets and projects, such as funds established to exclusively invest in renewable technologies. The development of sustainability linked finance has however begun to bridge the gap between green industries and traditional industries to assist the latter in achieving ESG targets. This has given aviation financiers a new tool with which to play their part in the wider aviation industry drive to reach net zero.

Sustainability linked finance works because it rewards borrowers through pricing for achieving defined ESG targets. This has most recently been developed in aviation through rewarding participating airlines with rent rebates and reductions in margins on their financing if said airline achieves periodic key performance indicators ("KPIs") which will assist in reducing its carbon output. This approach closely follows the guidance issued by various industry bodies around the world, including the Loan Market Association, the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association. For example, an airline and financier may agree that the airline will benefit from a reduced margin on its financing if the airline year on year increases its use of sustainable feedstock aviation fuel as a proportion of its annual aggregate fuel use. Or an airline and a lessor may agree, if the airline increases the proportion of more efficient new technology aircraft in its entire fleet, that it will receive a rent rebate.

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Conceptually, sustainability linked financing seems straightforward, but calibrating KPIs can be complex. If they are too easy to achieve, the borrower and the financier may be accused of green washing. If they are too difficult to achieve, the borrower may abandon them. Also, care should be taken not to cause a margin call effect on the borrower. If a KPI cannot be achieved because unforeseen circumstances have stalled a borrower's investment plans, such as an airline's fleet renewal plan to move to a more efficient fleet, the increase in pricing as a consequence of failing to achieve the related KPI across the borrower's financing would make it even more difficult, and therefore more unlikely, that the borrower will ever eventually be able to make the required investment and achieve the KPI. A method of addressing these issues has been to increase the applicable target periodically, so the borrower enjoys cheaper pricing from the beginning of the transaction, and also as a reward for continuous investment and achieving year on year improvements. Finally, KPIs must be capable of accurate measurement. Calibrating them by reference to inputs rather than outputs can address this requirement, for example, measuring new technology aircraft as a proportion of a fleet is easier than measuring how many tons of carbon are emitted by an airline over a period of time. Precise measurement also increases transparency for the wider general public.

Sustainability linked finance is therefore an effective strategy incentivising carbon reduction in the industry, not only assisting financiers in achieving their own ESG obligations, but also providing a double benefit for airlines. An airline already enjoys a benefit by adopting the technology which forms the basis of a KPI, even before it enjoys the reduction in its financing cost by achieving the KPI. Micro strategies, such as sustainability linked finance, do need to be widespread in order to have a significant impact, but sustainability linked finance is simplistic enough to be easily implemented which is likely to guarantee its place in the aviation industry's tool kit to reach net zero. At the date of this article, sustainability linked finance is limited to lender/airline finance (and has been deployed in various financing structures including JOLCO). In principle there is no reason why the technology cannot be extended to financing provided to lessors and to rentals paid for operating leasing. Such would require some thought around the applicable KPIs, but otherwise the existing framework, for example, with regards to reporting, should suffice. Might lessors and financiers even consider, is there any reason why existing transactions could not be amended to introduce sustainability KPIs, substantially increasing their use and therefore impact on reaching net zero?

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Benchmarking the deployment of new technology aircraft and the use of sustainable aviation fuels will also be significant factors in determining whether an economic activity in aviation, such as a finance or leasing transaction, can be considered as sustainable for the purposes of the EU Taxonomy Regulations (the "Regulations"). The Regulations are key to the EU's drive to net zero by 2050 by incentivizing private capital to invest in sustainable industries. The Regulations established six objectives to assess whether an economic activity was sustainable or not, including whether the activity mitigates climate change, which is the most relevant for the aviation industry. This is intended to provide a uniform and standard benchmark for investors and other industry participants to evaluate whether the economic activity in which they are participating is sustainable, which is of particular importance to many financial institutions in the EU as they have an obligation to report on matters related to sustainability in their annual financial statements. Criteria to assess whether an economic activity in a particular industry is sustainable is contained in the technical screening criteria developed for that industry by experts and relevant stakeholders, although in the case of aviation, such technical screening criteria remains in development and has not been finalized. Agreeing technical screening criteria for aviation has been challenging because aviation cannot currently be classified as a low carbon technology, leading some critics to argue whether it should be considered sustainable at all. Notwithstanding the critics, pursuant to the draft technical screening criteria, an economic activity in aviation can be classified as sustainable under the Regulations if it satisfies the criteria for transition activities. If, for example, the applicable economic activity is one of the best performers in terms of emitters of carbon in the industry, then it will be determined to be making a substantial contribution to climate change mitigation, one of the objectives of the Regulations, and contributing to the transition to a low a carbon economy. Next generation aircraft, at the cutting edge of carbon emissions, should fulfill this criteria, hence their inclusion as a KPI in sustainability linked loans and the requirement to use sustainable aviation fuel will also likely be included in the technical screening criteria on a similar basis. The technical screening criteria for aviation are expected to be finalized by the end of the year, however, further consultation could cause a delay.

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