Client Alert | Capital Markets

Green Loans Pave the Way for Green CLOs and Green RMBS

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Authors: Chris McGarry, Michael Bark-Jones, Mindy Hauman

While green bonds have been the darling of the capital markets for the past few years, there has not been the same level of discussion about green loans. We expect 2018 to be a transformational year for the green loan market with the emergence of the first green CLOs which may ultimately become the primary source of financing for green loans, in particular the longer dated green loans. There is certainly potential for developing a green loans market perhaps to complement the green bonds market but with slightly different characteristics.

Unlike green bonds, green loans have no set criteria or principles they are expected to meet. Some green loans comprise loan monies which are advanced on the condition that the borrower fulfils certain environmental undertakings, whilst others are advanced for any purpose, with the borrower being rewarded with a lower cost of funding the 'greener' their business as a whole is deemed to be by the lender(s) after a given time period.

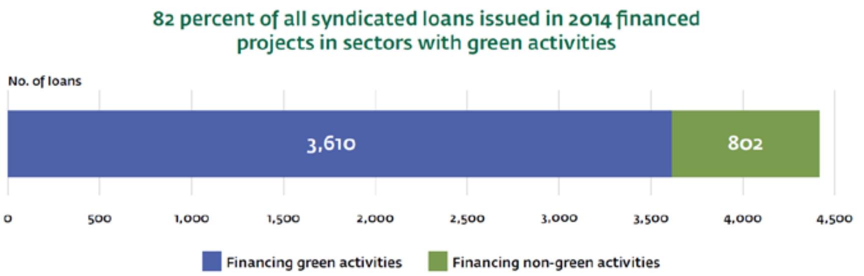
Green Loan vs Green Bond Financing

Why an entity would seek a green loan rather than a green bond will depend on the individual needs and circumstances of each potential borrower or issuer.

Bonds are of relatively high denominations, and with a longer tenor than most bank loans and they have a public credit rating. Loan amounts tend to be smaller than bond issuances, and are accessible by a greater range of entities including SMEs and individuals, as you can raise smaller scale finance than that required to make bonds economically worthwhile. In addition to green corporate loans, we expect exponential growth in the green mortgage market in 2018. As with corporate loans and green CLOs, we expect green RMBS to emerge as the primary source of funding for green mortgages. Homeowners are now able to obtain a "green mortgage" over a property, under which the money saved through energy efficiency in the relevant property is added on to the mortgagor's income for the purposes of calculating the level of funds that may be borrowed[1].

As a crossover product, some larger lenders may bundle up and securitise a portfolio of green loans in order to leverage the return through green securitisation. Scaling up smaller individual loans in this way makes the return on the income streams more commercially attractive. A key characteristic of loans which may make them more favourable than bonds in certain circumstances is their flexibility. As bank loans are governed predominantly by a set of (bilateral) contracts, the loan documentation can be tailored to individual circumstances than bond documentation.

1 We expect to see a regime of lower risk-weighting applying to green debt instruments which should also result in a pricing benefit to the consumer.



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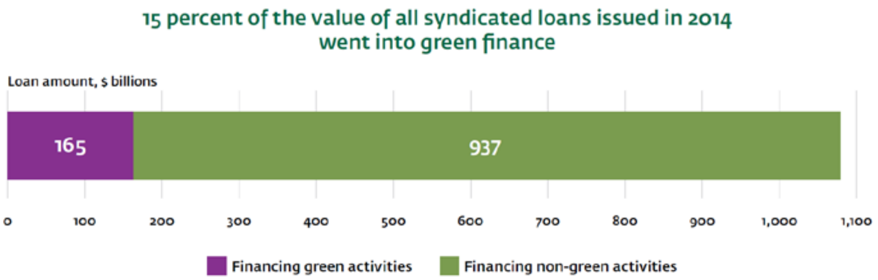


Source: IFC

Green Loans vs Standard Loans

In comparison to a standard loan, banks are able to get a better insight into the credit-worthiness of the borrower due to the in more in depth analysis of the underlying assets of green loans. Green loans make more attractive assets because, for example, in green real estate loans they are helping to improve the energy efficiency and sustainability of the underlying property which inherently makes it more valuable and therefore better collateral for the loan.

The European Commission High-Level Expert Group on Sustainable Finance recently released an interim report which considered the adaptation of prudential regulation, in particular the possibility of introducing "green supporting" and "brown penalising" factors[2]. This would be a positive development for smaller banks, which would be incentivised to agree more green loans from a regulatory capital perspective.

Pressure on companies to report on environmental impact is growing globally, both from government policy (e.g. the Task Force on Climate Related Financial Disclosures' (TCFD') recommendations) and from investors and shareholders (see e.g. shareholder legal action against Commonwealth Bank for failing to make environmental impact disclosures in its annual report) which will make it increasingly imperative for banks to build greener portfolios.

Green Loan Guidelines or Principles

A key difference between green bonds and green loans is the lack of universally recognised green loan principles, like the bond market's Green Bond Principles[3] (GBP). The GBP allow compatible criteria, tracking and mutual recognition across markets, and national authorities who have facilitated the globalisation of the green bond market. Clear principles and guidance have facilitated growth and innovation in the green bonds market based around those parameters, whilst still allowing for comparisons across green bond products. There is no equivalent harmonisation of green loans.

Unlike proceeds from bond issues, most syndicated bank finance is undrawn. When facilities are drawn, a template similar to Green Bond Principles can be used to apply the relevant funds to green projects. However, the application of use of proceeds rules would not be as straightforward for multiple-use revolving credit facilities. Guidelines would need to be devised for such instruments. There are some green facilities in the loan market but the guidelines are self-lead.

2 https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf

3 https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/GreenBondsBrochure-JUNE2017.pdf

A Difference in Liability

The question of liability for failing to address environmental undertakings and meet targets is an increasingly hot topic across green finance. The bilateral contractual nature of loans means that such consequences in a green loan context are relatively settled as compared to green bonds. For example, if a green loan fails to use the proceeds for green purposes, this can cause an event of default or trigger in-built penalties until the borrower cures it. In other market examples, if the quantitative sustainability targets set in a facility agreement are not met, a higher interest rate can be charged on a green loan. The consequences for failing to apply proceeds for the stated green purposes in green bonds do not have such penalties or mechanisms: instead bondholders rely on the tort of misrepresentation and other sanctions applicable to mainstream vanilla bonds.

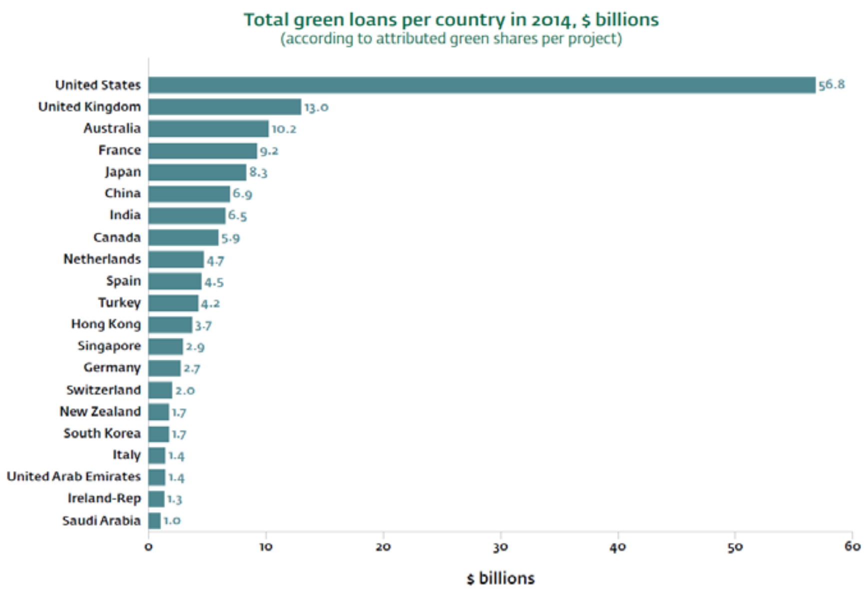
The bilateral or small lending group nature of loans means that their performance and penalties can be tailored to the circumstance and can be monitored for breach, which is not possible in widely held bonds.

Example Green Loans

There are some green loans that function similarly to green bonds and some even adhere to the Green Bond Principles. For example, in 2016 Lloyds Bank began a pioneering "Green Loan Initiative", where they allocated £1bn in green loans for borrowers to invest in improving the energy efficiency of their real estate. Borrowers meeting a certain internally set criteria qualified for green loans. The criteria evaluated the borrower's sustainability strategy and sustainability risks in the security backing the loan. As with green bonds, this primarily manifests itself through the pledging of proceeds of the loan to pre-approved green projects.

UK retailer Sainsbury's is a high profile borrower under Lloyds' initiative. Their loans are being used to finance renewables, energy efficiency, water use management and carbon reduction, with specific projects including investment in technologies such as solar panels, LED lighting and biomass boilers in their stores. This was the first time that a commercial loan had been structured to have the same effect as a green bond. Sainsbury's say the structure of the loan is consistent with the Green Bond Principles, with significant reporting obligations and a framework which has been independently verified[4]. Sainsbury's will prepare a continuing obligation to report on how the loan is being used to demonstrate adherence to the agreed green framework[5].

Lenders who have extended green loans on preferential terms in the Nordic market include public sector entities Kommuninvest in Sweden, KBN in Norway, KommuneKredit in Denmark and MuniFin in Finland. These lenders have recently used green bonds to refinance existing loans, opening the books up for more green loans to be agreed. The respective borrowers include municipalities for the purpose of financing projects within distinct categories.



Source: IFC

4 Sainsbury's Green Loan Framework

5 See, for example, Sainsbury's 2015-2016 Report on its green loan.

Green Incentivisation – Not Green Use of Proceeds

The lack of harmonised principles and criteria has allowed different green loan structures to develop. One structure has recently emerged which, unlike other green finance instruments, does not directly involve green use of proceeds; instead the loan margins are linked to the borrower's sustainability performance as a company overall. In other words, unlike green bonds, the returns on investments are directly dependent on environmental factors. This form of green loan was piloted by Lloyds, financing property company Unibail-Rodamco[6]. The interest margin of the loan[7] depends on Unibail hitting three green key performance indicators each year. How the proceeds of the revolving credit facility are directly applied is not restricted, however it is clearly in the borrower's interest to invest at least a proportion into becoming more sustainable in order to reduce the interest payable on the principal.

In the Nordics, Swedish real estate company Fabege and the Municipality of Gothenburg have successfully borrowed money under green loans. Both of these borrowers also have existing green bonds outstanding. The terms of these loans are not public but we understand that the key metrics used by banks providing such loans relate to an overall corporate sustainability rating from an independent party such as Sustainalytics, with pricing of the loan correlating to any changes on the overall corporate rating, and so are not aimed at specific use of proceeds. Other green loans rely on a form of penalty fee applying if proceeds are not used in accordance with the originally intended use of proceeds. Nordic lenders have avoided making a 'failure to comply with a use of proceeds' covenant or linking to the loss of a certain sustainability rating resulting in an event of default so far.

As an added incentivisation, the Fabege loan was provided on improved terms due to the green nature of the investments which was deemed a lower risk as green properties are seen as having lower vacancy risk[8]. This loan structure has been repeated by two consortia of lenders, both led by ING, financing health technology company Philips[9] and French chocolate-maker Barry Callebaut[10] respectively. Both companies' sustainability ratings were benchmarked by Sustainalytics, and interest margins depend on whether these ratings improve or decline. This green loan structure demonstrates a divergence from the standard methodology behind labelling finance instruments green. It is unclear how palatable such green loans would be to green investors but it does serve as an interesting alternative for borrowers such as oil and gas companies who have historically struggled to gain credibility as green bond issuers despite using bond proceeds to become more sustainable[11].

Future of Green Loans

SME finance

The flexibility of size and scale of green loans makes them inherently more accessible to SMEs than green bonds as a method of finance. Many SME projects and financing needs are better suited to green loans than green bonds. Numerous banks worldwide are now offering green loan facilities for SMEs, and if prudential regulation becomes more favourable towards them as envisaged by the European Commission, these offerings may exponentially increase. SMEs can also take advantage of various schemes incentivising investment in green technology, such as the Carbon Trust's "Green Business Fund"[12]. Some governments are also offering tax relief on certain green plant and machinery[13]. These incentives make green loans more attractive.

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6 Incidentally, Unibail also has issued several green bonds.

7 http://www.costar.co.uk/en/assets/news/2017/April/Lloyds-arranges-600m-Unibail-Rodamco-refi/

8 https://www.globalance-bank.com/en/themes-and-events/trends/environment/green-buildings-higher-return-lower-risk
https://www.bbhub.io/brief/sites/4/2017/03/03-2017_Green_Real_Estate.pdf

9 https://www.ing.com/Newsroom/All-news/ING-and-Philips-collaborate-on-sustainable-loan.htm

10 https://www.barry-callebaut.com/news/2017/06/barry-callebaut-couples-sustainability-its-renewed-banking-credit-facility

11 Spanish oil company Repsol's green bond issuance, for example, was refused certification by the Climate Bonds Initiative and the bonds were not listed on the major green indices however they would have easily obtained labelling as a green loan under this structure.

12 https://www.carbontrust.com/client-services/programmes/green-business-fund/

13 https://www.gov.uk/guidance/energy-technology-list

Infrastructure funding

Financing sustainable infrastructure will be a key factor for many nations trying to meet their nationally determined targets under the Paris Agreement to decrease carbon dioxide emissions. For example, approximately 50% of the greenhouse gas emissions in the UK are generated by the construction and operation of real estate[14], so sustainable projects in this sector may be in the impetus the UK needs to reduce national greenhouse gas emissions to 20% of 1990 levels. Bank finance is possibly the most important instrument in helping green infrastructure projects to get off the ground. Local banks are often better equipped to assess risk than institutional investors and the scale of individual projects means they are often best suited to loan financing. Most initial infrastructure financing is provided by banks in the form of loans[15], so green loan utilisation is set to increase.

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom

T +44 20 7532 1000

14 http://www.bwbllp.com/file/bwb-reupdate-grnloans-mar17-pdf

15 https://www.climatebonds.net/files/files/GB-Public_Sector_Guide-Final-1A.pdf