WINSTON & STRAWN LLP

CLIENT ALERT

ESG provisions in loan agreements: not much COP?

NOVEMBER 24, 2021

Consensus opinion on COP26 appears to be that the conference simultaneously achieved far more than expected and less than is required to save environmental catastrophe. Very much the same can be said of developments in ESG provisions in loan agreements, with a surprising amount of progress having been made, but still much to do.

Recent surveys by Covenant Review have suggested that more than 50% of new syndicated loans in the European market now contain ESG related provisions. This level was reached early in 2021 when it could have been attributed to low supply, but as the level has been maintained through 2021 it is difficult to deny that progress is being made by funders in the European market in addressing ESG principles.

This level of adoption is surprising, but it is reflected in the percentage of loans passing through our European Loan Review Centre, where we have seen more than 40% of loans addressing ESG factors and more than 30% including explicit ESG related margin ratchets. Progress seems to be significantly slower in other markets.

ESG provisions really only emerged in their current form in Europe in mid-2020, driven by investor appetite for socially responsible lending. Since then clauses have developed from narrow, exclusively environmental, criteria to encompass a broader basket of ESG factors, such as:

- commissioning and achieving a 'top tier' ESG rating by a third party rating provider
- maintaining policies requiring monitoring of key environmental, social and governance indicators
- achievement of zero net carbon emissions or percentage reductions in carbon emissions
- assessment of supply chains for human rights abuses, modern slavery and poor labour standards
- participating in initiative to improve local communities
- maintaining a corporate code of ethics

Those with exposure to development bank funding will notice a correlation with some of the factors already monitored by development banks.

Companies may be able to satisfy the test for a margin reduction by meeting only some but not all of these requirements in a given year, perhaps increasing year on year. Encouragingly, where agreed, the tests seem to carry a sense of ambition. However, it is striking that a number of the facilities leave the final ESG criteria to be determined after completion of the relevant financing (*Ed: another striking analogy to COP26*). This may be to allow for necessary calibration by management, but it is to be hoped that does not detract from setting ambitious targets for the life of the loan rather than setting targets which can be achieved in year one.

That said, it is clear that, in business, what is measured is (often) achieved. The success of these clauses in driving the monitoring and publication of data on relevant ESG factors, and in identifying the appropriate metrics, should not be underestimated. These clauses also drive this behaviour in mid-market companies, which stock market initiatives and Government requirements are less likely to reach in the short term.

Another key feature of these provisions is the level of margin reduction which a borrower receives by meeting ESG targets. Typically the margin will reduce by 0.05% (and, as a maximum 0.075%) on achievement of the criterial. Compare this with a typical reduction of 0.25% for reducing the leverage by one turn. This difference is not enough to be an overriding driver behaviour in a business.

It is striking that banks seem to be leading the way, with banks involved (though not exclusively) in all of the transactions we have seen with ESG ratchets so far. This chimes with the UK's stated intention to make London a "net zero aligned financial centre" which will "mobilise private finance quickly and at scale" to fund transition aware from carbon. But these measures are designed to make capital available and to drive decarbonization of the financial institutions themselves.

It can't be the function of lenders to drive improvements in ESG principles by accepting reductions beyond a certain point, when interest rates are already close to historic lows. Where criteria are met, margin reductions should be proportionate to the reduction in risk, otherwise good behaviour would be penalised and causing capital to flow elsewhere. If Governments do want to drive behaviour beyond that that, a more rational position would be for polluters and abusers to be subject to penalties rather than lenders have to take material reduction in return.

Important questions remain. For instance, if ESG principles are widely adopted, how do we ensure that less ESG compliant businesses that are nevertheless critical to society at a given point continue to be funded? It would be ironic Governments needed to step in to protect industries (such as coal) which are vital in the short term but are already having difficulties in securing insurance products.

However, the European loan market should be applauded for making strides in adopting ESG lending principles and demonstrating that these can be appropriately incorporated into market loan documents.
3 Min Read

Related Locations

London

Related Topics

Finance

Environmental, Social & Governance (ESG)

Aviation

Related Capabilities

Financial Services

Related Regions

Europe

Related Professionals

Ian Borman

Mounir Letayf

Jérôme Herbet

Mats G. Carlston