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Environmental, Social, And Governance:

Why Linking Loans To Sustainability Performance Is Taking Off

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PRIMARY CREDIT ANALYSTS

Michael Wilkins
London
(44) 20-7176-3528
mike.wilkins@spglobal.com

Corinne B Bendersky
London
+ 44 20 7176 0216
corinne.bendersky@spglobal.com

Key Takeaways

- The sustainability linked bank debt market, which grew nearly sevenfold in 2018, is quickly catching up to the more dominant and mature green loans market.
- A growing number of borrowers are tying interest margins to the environmental, social, and governance performance of entities.
- Improved transparency and credibility in setting, reviewing, and reporting sustainability performance targets would ensure robust growth and confidence in this evolving asset class.
- This could also help sustainability linked loans become a mainstream practice in the wider debt capital markets.

The sustainable finance market is continuing to evolve and develop innovative products to encourage improved environmental and social performance. With the launch of the Green Loan Principles in 2018, the bank market has become an important area of activity for sustainability focused financing. While the responsible loans market still represents a relatively small part of the broader capital markets, it is growing dramatically--up US$32 billion since 2018 and totaling a combined US$111.5 billion as of July 2019, according to estimates by Environmental Finance.

A growing number of companies are including sustainability in their corporate strategies and investment decisions. What's more, environmental, social, and governance (ESG) considerations are now also finding their way into loan pricing. So-called sustainability or ESG linked loans have emerged as the latest innovation for bank loans, both investment grade and speculative grade. These loan instruments and contingent facilities, including guarantee lines or letters of credit, aim to provide incentives for borrowers to set and achieve ambitious sustainability performance targets (SPTs). Currently, SPTs include any number of factors, including a company's ESG score from an external provider, key performance indicators, and other equivalent metrics tracking improvements in a borrower's sustainability profile.

S&P Global Ratings believes effective and standardized ESG disclosure is required to ensure that market growth for green bank loans is robust. In our view, effective disclosure would entail improving transparency and credibility in setting, reviewing, and reporting SPTs. Widespread adherence to initiatives such as the Sustainability Linked Loan Principles (SLLPs) will go some way to ensuring that disclosure is standardized. We believe that marrying effective disclosure with consistent reporting practices could help ESG linked loan pricing become a mainstream practice in the debt capital markets.

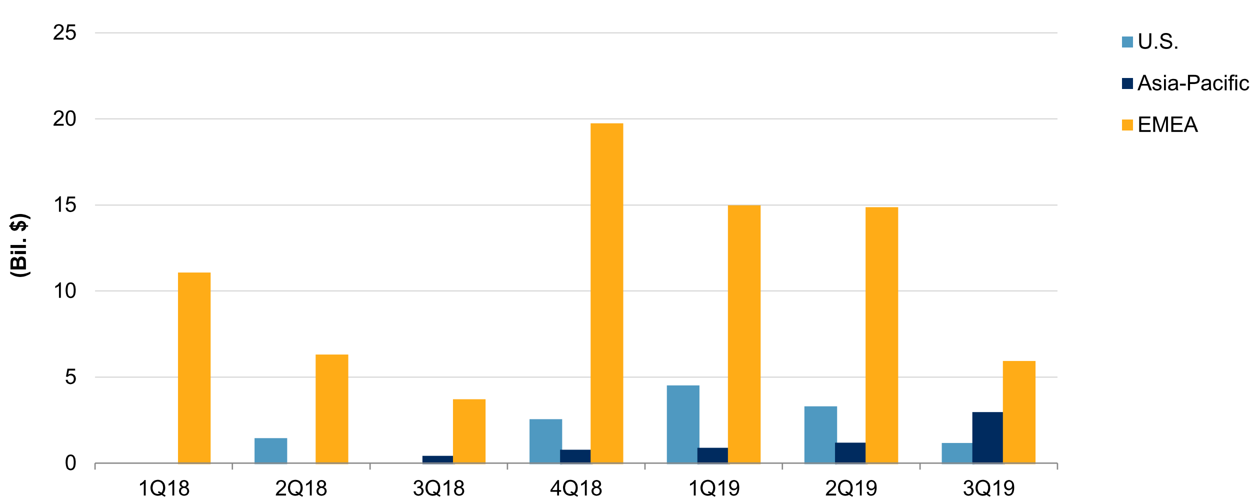
The Rise Of Sustainability Linked Loans

Since the first green-labelled loan closed in 2014, such instruments have dominated the broader responsible loans market, which comprises green loans and sustainability linked loans, and has a combined value of US$75 billion, according to a Bloomberg estimate. Although the first sustainability linked loan was issued in 2017, this segment of the bank debt market is quickly catching up. Last year, sustainability linked loans grew nearly sevenfold to US$36.4 billion, according to Bloomberg.

Europe leads in the issuance of sustainability linked loans, with borrowers and lenders in the region pushing the envelope to link loans to ESG performance (see chart 1).

Chart 1

Global Loans Linked To Sustainability Performance Targets



EMEA--Europe, the Middle East, and Africa. Source: Bloomberg.

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For example, Spain's fourth-largest telecoms operator, Másmóvil, in July 2019 issued the first loan in Europe to include an ESG component in a leveraged loan package. The €1.7 billion financing package included a €100 million revolving credit facility (RCF) and a €150 million capital expenditure (capex) line with the interest rates on the loans tied to the ESG Evaluation score on Másmóvil. The ESG Evaluation score of 67/100, which S&P Global Ratings gave to Másmóvil in July 2019, serves as the initial reference benchmark for determining changes in the interest rate on both the capex line of credit and the RCF, according to Másmóvil. If the ESG Evaluation score deteriorates, the interest rate on the loan will rise by 15 basis points; if it improves, the rate will decrease by 15 basis points. In Europe, the typical impact is usually plus or minus 5% to 10% of the margin, depending on the cost of capital, according to ING.

Másmóvil's loan is by no means a market exception to loans linked to an ESG score. In early 2018, France-based Danone partnered with 12 lenders to link its €2 billion syndicated credit facility to an independently verified ESG score--thought to be the first instance of a company explicitly doing so. Later that year, Adelaide Airport in Australia took out an A$50 million loan with an interest rate linked to the airport's ESG score.

There are also instances of borrowers choosing specific ESG criteria against which they are scrutinized, such as U.K. recycling company Renewi, which linked the interest rate of its €550 million green loan with its environmental performance in areas such as recycling, greenhouse gas emissions, and vehicle fleet efficiency. Another example comes from Pearson, a U.K.-based publishing and education company, which took out a US$1.2 billion RCF in late February 2019 with a margin adjustment linked to a social target, namely increasing enrollment in Business and Technology Education Council courses.

Evidently, there is demand in the market for loans that do not only serve to refinance existing debt, but also offer flexibility for further growth in line with ESG criteria. However, the market has also voiced concerns, namely: How to define and disclose ESG credentials to ensure the credibility of the sustainability linked label.

Transparency And Best Practice

The need for transparency and effective sustainability-related disclosure in such transactions is clear, particularly when such factors are directly influencing loan pricing.

The Green Loan Principles emphasize this need for transparency to safeguard the credibility of the "green" label, stating that tracking must show how proceeds from green loans go toward specific green projects. While this ensures transparency about the appropriate allocation of funding, it also serves to lessen the risk of "greenwashing," whereby a company disseminates misleading or unsubstantiated claims regarding the environmental benefits of company practice.

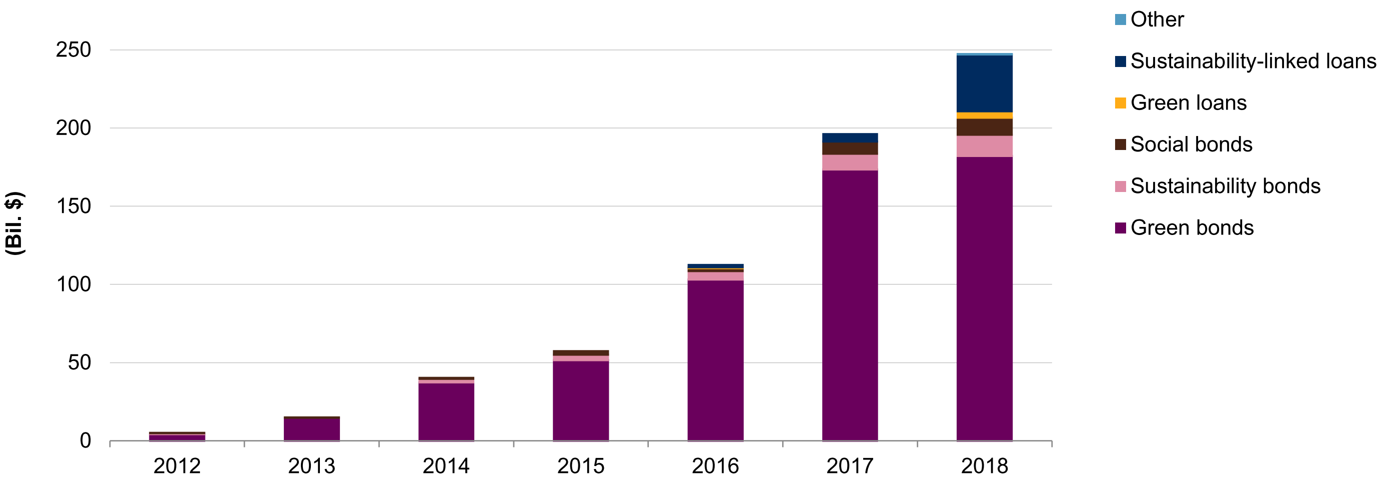
In a similar vein, the Loan Market Association, Asia Pacific Loan Market Association, and the Loan Syndications and Trading Association in March 2019 published Sustainability Linked Loan Principles to improve disclosure practices in the sustainability linked loan market. The SLLPs have four core components, spanning:

- How a sustainability linked loan product must fit into the borrower's broader corporate social responsibility strategy;
- The setting of appropriately ambitious SPTs for each transaction;
- Reporting practices on progress in meeting SPTs;
- The value of using a third party to review and verify a borrower's performance against its SPTs.

In contrast to Green Loan Principles, under the SLLPs the sustainability linked label is not dependent on dedicating loan proceeds to defined green projects. Instead, a borrower can apply the "sustainable" label to any type of loan instrument that provides incentives to pursue ambitious, predetermined sustainability performance objectives and improve its overall sustainability profile. This significantly broadens the types of loan facilities that can be linked to sustainability objectives to include letters of credit, various capital lines, and RCFs (such as those from Másmóvil and Adelaide Airport).

Chart 2

Growth Of Sustainable Finance Instruments



Source: BloombergNEF.

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In our view, it is important to address concerns about self-reported and unaudited performance data as well as self-policed and self-determined objectives for sustainability labeling. Indeed, SPTs that are set, measured, and reported internally pose the equivalent risk of "greenwashing," namely "ESG washing," in the sustainable loan market. Investors could be dissuaded by a market where companies could misreport performance and where a variety of company-specific targets could make benchmarking difficult.

That said, robust transparency could lessen many of these risks. For example, Másmóvil's ESG-linked loan package includes strong transparency, given that pricing advantages are explicitly linked to an independent ESG Evaluation score by a third party. The SLLPs strongly recommend the use of a qualified third party to review whether the borrower has met SPTs--for loans where information is made publicly available as well as for those whose details are private.

External review of borrower performance against SPTs is one potential solution, particularly as meeting ESG targets unlocks favorable interest rate incentives that could translate into material financial savings for the borrower. Moreover, these savings come directly from lender margins. So it may be in the interest of lenders to use a third-party assessment to reconcile qualitative nonfinancial SPT criteria with quantifiable financial benefits or penalties.

Enhancing Investor Insight

Assessing ESG performance is inherently a complex task. While investors have often relied on credit ratings to qualify the default risk an entity faces, ESG performance analysis demands a more holistic perspective.

For example, we recently rated Másmóvil 'BB-' with a stable outlook and separately gave the company an ESG Evaluation score of 67 out of 100 points. Alone, its credit rating communicates to investors that we believe Másmóvil has the capacity to meet it debt obligations commensurate with a 'BB-' level of creditworthiness. The ESG Evaluation, however, looks at the entity's performance on 12 key ESG factors and the impact these may have on stakeholders.

What Is An ESG Evaluation?

S&P Global Ratings' ESG Evaluation is a cross-sector, relative analysis of an entity's capacity to operate successfully in the future and is grounded in how ESG factors could affect stakeholders and potentially lead to a material direct or indirect financial impact. It aggregates an overall ESG Profile score (comprising three separate scores for Environmental, Social, and Governance) and an opinion of the company's ESG preparedness. It provides investors with insights into the opportunity and risk profile of an entity, incorporating analysis of both the region and sector and an assessment of its ability to adapt to emerging and disruptive changes over a long-term horizon.

By focusing solely on an entity's performance on ESG factors and ensuring the score can be adjusted in the event of changes that could materially affect it, an ESG score could be linked to a margin ratchet for a sustainability linked loan. Investors may also stand to gain added insight from the stand-alone ESG score, which could allow for benchmarking.

Focused ESG performance analysis is not only relevant to ESG-linked loan pricing. In August 2019, ING announced the first-ever sustainability improvement derivative (SID), linked to the price of an interest rate swap provided by the bank to SBM Offshore. Similar to an ESG-linked loan, the SID's price is linked to SBM Offshore's independently assessed ESG performance, alongside trading risk, capital requirements, and profit, according to ING. Over time we expect there to be further innovation in linking sustainability performance to other capital market instruments.

We think that sustainability focused financing acknowledges an underlying advantage of ESG performance analysis. Some empirical data suggests there may be a link between strong performance on ESG factors and improved corporate financial performance and investment returns (see "The ESG Advantage: Exploring Links to Corporate Finance Performance," published on April 8, 2019). Although much more research needs to be done in this area, we believe independent and consistent analysis of ESG metrics can help anticipate potential financial risks and opportunities in the longer term, such as evolving environmental regulations and disruptive technological advancements. For companies with speculative-grade ratings, comprehensive ESG risk analysis could also be a means of providing added insight for investors and influencing market sentiment for leveraged loans.

The incorporation of ESG factors into sustainability linked loans is still in its infancy, and we have yet to see how this market will develop. But increasing standardization and transparency, as well as forward-looking and holistic risk assessments, could lay the groundwork for borrowers and lenders to increasingly embed ESG not only into financial decisions but financial instruments too. As such, the sustainability linked loan market is in our view poised to expand further. Indeed, with the right tools, this market could be on the cusp of impressive growth, which may further spur sustainable business practices around the globe.

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Related Research And Criteria

S&P Global Ratings research

- Environmental, Social, And Governance (ESG) Evaluation: Másmóvil Ibercom S.A., July 11, 2019
- 2018 Annual Global Leveraged Loan CLO Default and Rating Transition Study, June 19, 2019
- Environmental, Social, And Governance Evaluation Analytical Approach, April 10, 2019
- The ESG Advantage: Exploring Links To Corporate Financial Performance, April 8, 2019

Other research

- "Introducing the world's first sustainability improvement derivative," ING press release, Aug. 13, 2019
- "Sustainability Linked Loan Principles," Loan Market Association, March 2019
- "Chinese Food Giant Raises $2.1 Billion in Country's First Sustainability Loan," July 16, 2019
- "MASMOVIL achieves a 67/100 ESG rating from S&P," Masmovil press release, July 11, 2019
- "Green and sustainability loans: the growth accelerates," Environmental Finance, July 1, 2019
- "ESG loans broaden access to sustainability linked financing," GreenBiz, March 6, 2019
- "Sustainable Debt Market Sees Record Activity In 2018," BloombergNEF, Jan. 11, 2019
- "Green Loan Principles," Loan Market Association, December 2018

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