By Ben Wilkinson, Nick O'Grady, Connor Lovie, Ben Bierwirth and Natalie Butchart of Baker McKenzie's London office

November 2021

ESG Margin Ratchet

In this edition of In The Know, we look at Environmental, Social and Governance (ESG) standards in Sustainability Linked Lending (in both loans and bonds). We address the ESG margin ratchet, how it interacts with ESG targets and testing strategies, and potential reinvestment obligations arising out of those interest savings, in each case, within the European leveraged finance market.

Introduction

Sustainability Linked Lending (SLL) is any type of loan or bond instrument that incentivises the borrower to achieve ambitious, predetermined sustainability performance targets (SPTs).[1] In contrast to Green Loans or Bonds where the focus is on the use of proceeds (applied exclusively toward Green Projects), SLL focuses on the borrower and its observance and development of ESG standards over time.[2]

For borrowers, SLL provides more than just liquidity; improved credit worthiness is available to those who put ESG standards at the forefront of their business. For investors, SLL may be at the core of their investment strategy (or even a requirement for some) and may increase returns on investment — they help strengthen relationships with stakeholders throughout the communities in which they and their borrowers operate. For both sides, SLL offers positive reputational impact and increased brand awareness while helping to promote an ever-growing awareness and commitment to long-term sustainable growth, diversity and inclusivity, and environmental protection. Yet, for the parties involved, many of the rewards of these benefits can take considerable time to come to fruition. These longer-term rewards, however, are being complimented by the comparatively immediate tangible benefits that can be realised by the application of an ESG-linked interest margin ratchet ("**ESG Margin Ratchet**").

1 Loan Market Association, "*Guidance on Sustainability Linked Loan Principles*", May 2020.
2 "Green Projects" are projects including, but not limited to, the categories of projects set out in Appendix 1 to the LMA's "Green Loan Principles". Examples of such categories include (i) renewable energy; (ii) pollution prevention and control; (iii) clean transportation; and (iv) climate change adaptation. For further reading, please see: Loan Market Association, "*Green Loan Principles*", March 2018.

The ESG Margin Ratchet

Margin ratchet

Margin ratchets are provisions that tie the rate of interest to a borrower's operational performance. In a traditional leveraged facility margin ratchet, the interest payable on any one loan is reduced by a pre-agreed number of basis points if the borrower can evidence that: (i) no Event of Default has occurred and is continuing; and (ii) the ratio of debt-to-earnings falls within a certain threshold. In addition to containing such provisions, many SLLs contain ESG Margin Ratchets. These provide for a further reduction and/or increase in the interest rate (as applicable), depending on the borrower's performance against pre-agreed ESG-related criteria and targets.

Application, testing frequency and pricing

Although SLL has become increasingly common, it is still in its infancy, and an industry standard for margin reduction levels, testing frequency, and ESG criteria and targets has yet to emerge. However, the trends and terms that the European leverage loan market has shown to date indicate that where the borrower is able to evidence that: (i) no Event of Default has occurred and is continuing; and (ii) it has met a certain number of its ESG criteria and/or targets, the ESG Margin Ratchet will apply and the borrower will benefit from a lower interest rate. In slight contrast, in the bond market, ESG Margin Ratchets (which in certain cases take the form of premiums payable upon maturity or early redemption) will impose a penalty upon failure to meet certain ESG criteria and/or targets, rather than a potential lower interest rate upon success.

Borrowers and investors appear to have agreed upon testing ESG performance once annually in loans, with the ESG Margin Ratchet also adjusting once annually by reference to the ESG annual compliance certificate. This is in contrast to a leveraged facility margin ratchet, which is typically adjusted quarterly by reference to a borrower's performance during those period.

Bonds usually fall on the other end of the spectrum, with only one testing date and step-up date (usually falling about half-way to maturity) upon which the ESG-Margin Ratchet either applies going forward or does not. In bonds, especially where the make-whole premium applies until maturity, this can be quite onerous to the borrower as a missed target will permanently increase the cost of borrowing until maturity or early redemption.

From a pricing perspective, current trends indicate that an ESG Margin Ratchet tends to affect the interest rate between 5 and 15 basis points per increment. A leveraged facility margin ratchet customarily reduces across a range of 10 and 50 basis points per step down. The rationale for a more conservative ESG Margin Ratchet may be that ESG terms remain in their infancy and neither borrower nor investor is, as yet, prepared to commit to a material effect on interest based on terms that have not been adequately tested and scrutinised in practice.

It should be borne in mind that the ESG Margin Ratchet is a tool to incentivise borrowers to achieve and then maintain a certain ESG standard, especially in the loan market where it is tested annually. Therefore, not only should a borrower strive to meet its ESG targets and, thereby a reduced interest rate, it should also ensure that the interest rate does not increase by not letting those standards slip. Accordingly, in many loan deals, where the borrower falls short of achieving those targets, the ESG Margin Ratchet operates as a two-way system: (i) enabling the investor to increase the margin; and (ii) consequently applying pressure on the borrower to rectify course in order to achieve its ESG targets to reduce the interest.

As an aside, thus far we have not seen the failure to meet ESG targets alone as constituting a Default or an Event of Default as the provisions have been presented as collaborative incentives to fulfil a common goal of borrowers and investors to improve the contribution financing makes to the wider issues and concerns underlying ESG targets. However, it remains to be seen whether failure to achieve ESG targets will ultimately constitute a Default or an Event of Default trigger. To that end, investors may consider not only the consequences of a borrower's failure to achieve its ESG targets, but also whether inaccurate reporting of ESG performance would constitute a breach — and if additional rights should be available to lenders in those instances as a result.

Measuring ESG performance

A borrower's ESG performance is measured in one of two ways for the purpose of SLL. One is by using predetermined SPTs, which is most prevalent (especially in the bond market). The other, which we have observed in certain loans, is by obtaining a Third Party ESG Rating against which all future performance is measured.

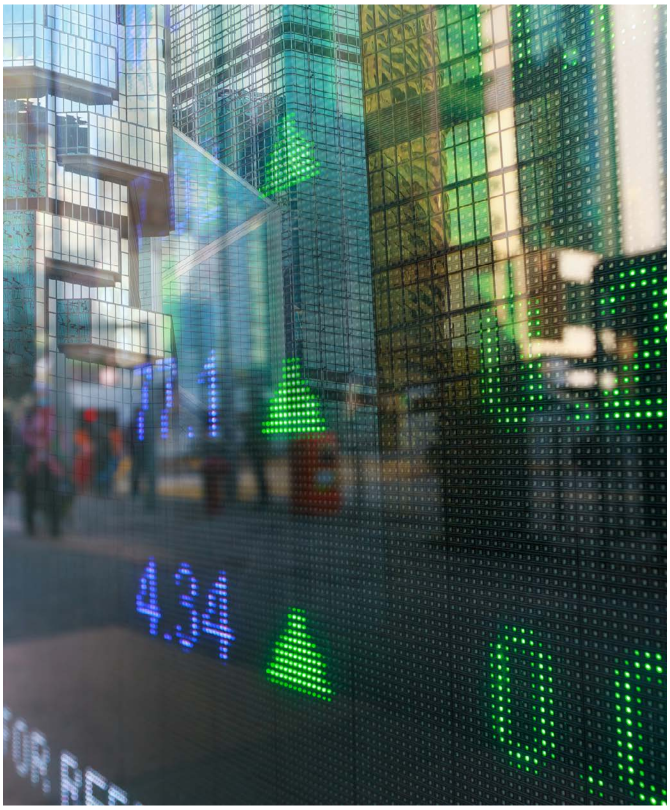
Sustainability performance targets and key performance indicators

SPTs should: (i) be clearly identifiable in the loan documentation; (ii) have definite and transparent metrics against which they can be measured; and (iii) extend from two to five key ESG performance outcomes (in each case, as agreed between the borrower and investor). Crucially, with regard to SPTs, these should be challenging and ambitious targets that not only address, and are consistent with, the borrower's strategy and core commercial and sustainability targets, but the industry sector in which the borrower operates as well. Testing of such SPTs and second party opinions are critical parts of the sustainability frameworks put in place at the time of the initial loan/bond issuance and are key (in the bond context) to the disclosure required to protect investors.

Borrowers must arrive at SPTs with transparency and accuracy, and a genuine desire to improve ESG standards. It is therefore not enough to produce loose-fitting targets, nor is it acceptable to settle on targets that are not: (i) truly underpinned by the promotion of ESG standards; and (ii) representative of sustainability goals within the borrower's industry.

SPTs must therefore be authentic and not represent ulterior agendas (so-called Greenwashing) in order to supercharge a marketing strategy, or drive up profits, without making concrete inroads into improving ESG standards. By way of example, the reduction of CO2e emissions by a pre-determined percentage year-on-year may be considered a legitimate SPT for a borrower operating in the automobile industry. On the other hand, encouraging guests to reuse towels to reduce a hotel's carbon footprint would not be considered a legitimate SPT if, in fact, it was masking a strategy to reduce overheads. In the automobile example, the SPT can readily be seen as core to the borrower's industry and sustainability targets.

The extent to which the borrower achieves its SPTs is generally determined by reference to Key Performance Indicators (KPIs), and external third-party verification will generally be required. In the automobile example, an appropriate KPI could be the percentage reduction of emissions on an average basis across a sample of vehicles in one year relative to the previous year.



ESG Ratings

The other, less prevalent, approach adopted in certain loans is to obtain an ESG Rating against which future performance is measured. Typically the ESG Rating is determined as at the date of the credit agreement or initial utilisation by an ESG Rating Provider appointed by the borrower and approved by the investors. The rating provides a holistic overview of the borrower's ESG profile in contrast to the more granular SPT approach and establishes a benchmark pursuant to which future performance can be assessed.

Ratchet application

If the ESG Rating on the testing date shows an adequate level of improvement (as defined in the documentation) on the benchmark rating, the ESG target is deemed to have been achieved and the ESG Margin Ratchet shall apply.

With the SPT approach, if the borrower can evidence that a pre-agreed number of KPIs are equal to or in excess of their corresponding SPTs, the ESG Margin Ratchet shall apply. If only one KPIs is equal to or exceeds its corresponding SPT, the ESG Margin Ratchet tends to be unmoved. If there are no KPIs equal to or in excess of the corresponding SPTs, the ESG Margin Ratchet tends to go the other way and impose a premium on the margin. In the bond world, failure to achieve each SPT will generally result in an increase in the interest rate pursuant to the ESG Margin Ratchet, whereas achievement of all the SPTs will keep the interest rate at the base level. If for instance three

SPTs are being tested, failure to meet an SPT could have a 15bps impact on the annual rate of interest for each SPT not achieved; therefore, the maximum increase (if all three SPTs were not achieved) would be an increase to the interest rate of 45bps, whereas achieving all three SPTs would have no impact on the interest rate.

Reinvestment obligations

Borrowers who are prepared to supercharge their ESG commitments may agree to a hybrid Green Loans approach whereby they reinvest any savings made as a result of the ESG Margin Ratchet into ESG projects, charities or initiatives. This obligation may be imposed upon the borrower, although widespread acceptance of these obligations has not yet been seen in the market.

Those who do accept reinvestment obligations may consider caveating these obligations with "reasonableness" or "reasonable endeavors" and should ensure that the provisions are broad enough to permit reinvestment across a range of ventures. By contrast, investors should ensure that the drafting is sufficiently prescriptive to prevent the borrower from wriggling off the hook and retaining the savings for a non-ESG purpose. Irrespective of the side of the table on which one is sitting, any reinvestment provisions must be sufficiently palatable to borrowers in order to incentivise them to meet the qualifying ESG criteria/targets.

Given the limited inclusion of these provisions to date, it is not clear what penalties a borrower can expect to befall them if they fail to comply with their reinvestment obligations. Hypothetically, an appropriate structure may be to align these reinvestment provisions to those akin to typical mid-market mandatory prepayment terms, such as, any savings must be committed to be applied within 12, or 18, months and actually applied within 18, or 24, months. Failing compliance with these timeframes, ESG savings could be applied either: (i) in prepayment of the loan; or (ii) having regard to ESG standards, toward an ESG initiative as the investor may otherwise direct. We have yet to see such mechanics in the bond market.

Closing remarks

It will likely only be with the passage of time and once the market has seen an appropriately sized SLL sample that any precedents will be set. For the time being, therefore, ESG Margin Ratchet provisions and testing metrics continue to evolve. Borrowers and investors should respond by continuing to approach these provisions having regard to their own operational and industry requirements, and with a view to improving and developing their own environmental, social and governance profiles.

TO SIGN UP TO RECEIVE OUR NEWSLETTER, PLEASE CLICK HERE

TRANSACTIONAL POWERHOUSE

Contacts

Ben Wilkinson
Partner | London
Ben.Wilkinson@
bakermckenzie.com

Nick O'Grady
Partner | London
Nick.OGrady@
bakermckenzie.com

Connor Lovie
Senior Associate | London
Connor.Lovie@
bakermckenzie.com

Ben Bierwirth
Senior Associate | London
Ben.Bierwirth@
bakermckenzie.com

Natalie Butchart
Lead Knowledge Lawyer | London
Natalie.Butchart@
bakermckenzie.com

bakermckenzie.com