By Rob Mathews, Samantha Greer, Adam Farlow, Caitlin McErlane, Megan Schellinger and Maxim Khrapov of Baker McKenzie's London office

September 2020

TOP TEN TIPS FOR ESG DEBT FINANCINGS

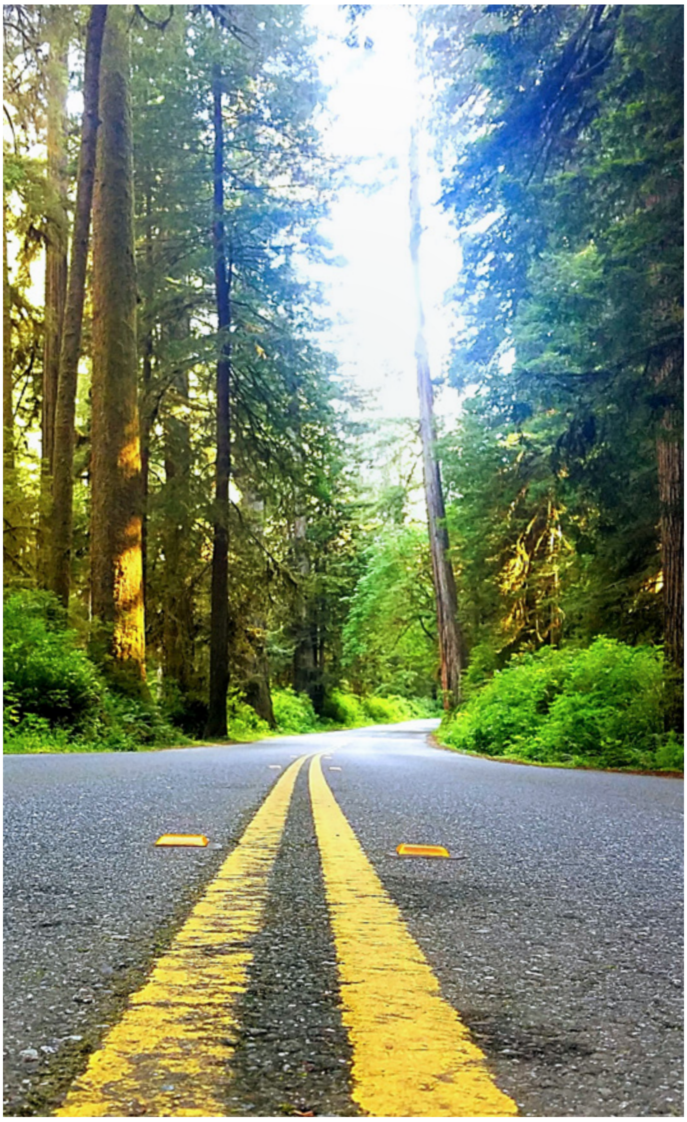
Navigating the challenges and opportunities presented by the rapidly-growing and evolving financial markets for environmental, social and governance ("**ESG**")-related bonds and loans can be a daunting undertaking. In this issue of *In the Know*, Baker McKenzie lawyers share their experiences and insights.

FACT: *ESG finance requires immediate attention*—All market participants urgently need to develop or continue to develop ESG expertise, including, importantly, for ESG-related debt finance activities. Not only are there altruistic reasons to undertake these initiatives, but stakeholders, activists and governmental authorities, among many others, are demanding action.

FACT: *ESG finance is here to stay*—Urgent environmental, social and governance drivers across all industries and jurisdictions will fuel ESG-related growth into the foreseeable future and beyond, and finance initiatives provide a direct link to fund this growth.

FACT: *ESG finance is still in its early days*—Protocols are voluminous and confusing, ESG-related products continue to evolve, benefits are (currently) primarily non-economic, and risks remain uncertain.

So what do you need to know? We've set out below our top ten tips for ESG debt financings:



1. Select your shade of "green".

The challenge: Terms that are often connected to ESG finance, such as "green", "social" and "sustainable", have different meanings across markets and products, and these categories are subject to widely-varying guidelines and implementations. Ironically, the regulatory and legal frameworks established to facilitate the development of the ESG bond and loan markets (including third party review procedures and strict use of proceeds requirements) may actually be slowing its growth in certain circumstances. One reason for this is that, to date, the economic benefits to a borrower of implementing an ESG financing (for example, better pricing or better terms) have been somewhat limited; based solely on a finance cost-benefit analysis, the additional cost and effort to issue and maintain an ESG financing may act as a deterrent, regardless of the importance of the social impact.

The good news: *First,* procedures for compliance with ESG debt finance guidelines and regulations are becoming more streamlined, and include more flexibility for the application of proceeds and better-established monitoring practices. *Second,* alternatives have quickly developed for ESG debt financings outside of the stricter "green" protocols to address a broader spectrum of environmental and/or social goals, including ESG debt finance products that are specifically designed to confer an economic benefit (known as sustainability-linked or KPI-linked bonds or loans, as further described below). This is good news for debtors and investors, not only because it provides them with a more diverse range of options for taking ESG-related financing actions, but also because it incentivizes corporates who may not be able to fit into the traditional "green bond" or "green loan" framework to demonstrate their commitment to ESG objectives in a variety of creative ways.

2. Choose the right ESG product.

As the ESG market develops, market participants continue to look for different ways to address global ESG concerns. While the scope of categories of ESG financings is constantly evolving, the sample list of products below indicates that there is a wide range of financing alternatives for both bonds and loans that fall under the ESG debt finance umbrella.

ESG Product	Main Characteristics
Primary Classifications	
Green	Use of proceeds used to finance projects that have an environmental and/or climate benefit.
Social	Use of proceeds used to finance projects with a positive social outcome, such as improving health services, affordable housing, diversity and/or infrastructure.
Sustainability	Use of proceeds used to finance projects that have environmental, climate and/or socio-economic benefits (i.e., a combination of green and social aims, often aligned with a company's corporate social responsibility ("**CSR**") initiatives).
Other Classifications	
Transition	Use of proceeds used to help companies operating in "brown industries" (for example, with traditionally high greenhouse gas emissions) improve their ESG profile, where the use of proceeds would not otherwise be sufficiently "green" to justify classification as a green bond or loan.
Sustainability-linked or KPI-linked	Company is incentivized (for example, via a change in the interest rate) to achieve certain performance targets relating to specified ESG-related key performance indicators ("**KPIs**"); use of proceeds does not need to be applied towards ESG-friendly initiatives and can be used for any purpose.
Blue	Use of proceeds used to finance marine or ocean-based projects that have an environmental and/or climate benefit.

3. Any industry can play.

While certain industries are obvious targets for ESG-related initiatives, corporates in any industry can find a way to support ESG objectives through their funding activities. Companies operating in industries such as mining, energy, utilities, transportation and agriculture can readily establish easily identifiable green targets. For others, companies that have established CSR or similar policies can use these as a starting point to identify potential areas to address, including health and safety, diversity and mental health support, among many others.

Once the relevant goals are identified, the next step is to link the company's financial objectives with ESG milestones and, importantly, determine a path to effectively promote the ESG aspects of the financing to potential investors and interested third parties. As these products continue to develop, we expect to see more creative examples from market participants, and the scope of ESG-related activities to broaden.

4. Pick your poison (remedies for missing objectives).

To date, investors have generally relied on the good faith efforts of the borrower or issuer to ensure that their investment is or will remain ESG-compliant. While offering documents typically include risk factors to the effect that ongoing ESG compliance may not be maintained, contractual or economic penalties for non-compliance are currently rare in use of proceeds financings. While this position arguably benefits issuers and borrowers in the short term, as the ESG debt finance market evolves and grows this topic is gaining more attention, and we believe one or more mechanics will emerge to provide investors with some level of comfort that their investments will remain ESG-complaint. Options could include:

- Interest Rate Ratchet: Automatic increases in the interest rate during any period in which the issuer does not meet the applicable ESG criteria (we are already seeing this in certain sustainability-linked loans with a two-way pricing structure, as further described below).
- Investor Put: Allowing investors to decide whether or not to stay in the issue (similar to a change of control offer or asset sale offer).
- Issuer Call: Allowing the issuer to repurchase or redeem the issue if the reason for non-compliance is outside of its control (similar to a tax redemption).
- Default: Default trigger requiring repayment of the debt instrument at par (or perhaps even including a "make-whole" premium).
- Contractual Representations and Warranties, and Indemnification: Provisions that would give rise to a contractual claim for continued failure to meet the applicable ESG objectives.

While a default trigger would seem too harsh a penalty to be widely accepted by issuers and borrowers, some combination of the above may be appropriate to maintain the balance between flexibility for the debtor and protection for the investor.

5. Maximize the benefit to you.

One of the most obvious advantages for companies looking to tap the ESG debt finance market is the reputational benefit. Issuers and borrowers initiating ESG financings signal to the market that their prioritization of ESG objectives is aligned with the global ESG agenda. Financial institutions participating in these financings, such as bookrunners or arrangers, benefit from a similar reputational boost.

While the reputational aspect is not an insignificant one, issuers and borrowers may be glad to know that a specific class of ESG debt finance products—sustainability-linked or KPI-linked loans or bonds—can confer an economic benefit as well. These products are structured in such a way that the borrower or issuer is incentivized to achieve certain predetermined ESG-oriented performance targets that may not necessarily have anything to do with the financing itself; the use of proceeds for sustainability-linked or KPI-linked loans or bonds does not need to be earmarked for ESG initiatives. One of the most common incentives for sustainability-linked or KPI-linked loans or bonds is a decrease in the interest rate, but there is room for creativity here in the structuring of other financial incentives. Therefore, if a potential issuer or borrower wishes to take full advantage of a sustainability-linked or KPI-linked product, it should negotiate a pricing structure that maximizes the economic rewards for achieving its performance targets. For example, while sustainability-linked loans often include a step-down in the margin upon achieving the relevant ESG objective, a pricing structure with better incentives would include step-downs in both the margin and the commitment fee so that the borrower reaps the benefit of meeting or exceeding its ESG targets regardless of whether the loan is drawn or undrawn. Recently, two-way pricing structures have also been observed in the market whereby pricing decreases if ESG performance targets are met, but increases if performance worsens.

Finally, the issuance of ESG finance products also allows companies to respond to growing investor demand for ESG investments, and to access an expanding pool of capital specifically allocated for ESG investments that would otherwise be unavailable to them. See "*Know your investor base (and develop an effective marketing strategy to reach investors)*" below for additional tips geared towards maximizing investor appeal.

6. Consider ongoing disclosure and reporting obligations.

Borrowers and issuers in ESG debt financings are expected to commit to provide regular ESG updates to their creditors, but the content and preparation of those reports can vary significantly depending on the particular ESG product issued, the expectations of lenders and investors, as well as the borrower's or issuer's own willingness to take on enhanced reporting responsibilities. For example, in the green bond context, post-issuance reporting on the application of the use of proceeds—that is, the allocation of proceeds to eligible green initiatives and a description of those initiatives—can be distinguished from post-issuance reporting on the bond's environmental impact, as assessed against qualitative and quantitative performance indicators. Annual use of proceeds reporting is a central component of the Green Bond Principles and Social Bond Principles (issued by the International Capital Markets Association ("**ICMA**") and further described below under "*Adopt a jurisdiction-specific financing strategy*"), as well as the Green Loan Principles (issued jointly by the Loan Market Association ("**LMA**"), the Asia Pacific Loan Market Association ("**APLMA**") and the Loan Syndications and Trading Association ("**LSTA**")), but impact reporting is also encouraged. A 2019 report issued by the Climate Bonds Initiative found that two-thirds of green bond issuers provide ongoing use of proceeds reporting, but only about half of green bond issuers provide ongoing impact reporting.[1] As a separate example in the context of sustainability-linked loans, the Sustainability-Linked Loan Principles issued jointly by the LMA, APLMA and the LSTA similarly envisage annual reporting on a borrower's progress as to its predetermined ESG performance targets, and encourage borrowers to publicly disclose their efforts. Borrowers and issuers may also opt to engage independent reviewers to oversee their ESG performance and/or certify their ESG processes against external performance standards. While this kind of third party oversight is not strictly required, it can help to lend further credibility to a company's ongoing ESG reports.

It is worth reiterating that while the market has come to expect some form of ongoing ESG reporting from issuers and borrowers looking to participate in ESG financings, the principles that have guided reporting practices to date remain largely voluntarily, and the specific parameters of a debtor's ongoing reporting obligations (including the need for independent third party review) are often negotiated on a case-by-case basis over the course of each individual transaction.

Separately, investors are now increasingly demanding that issuers and borrowers looking to access leveraged finance markets issue standardized ESG disclosure (for example, as part of marketing materials or deal documentation), even if the contemplated transaction is not specifically structured as an ESG debt financing. This is illustrative of a more widespread trend arching towards greater transparency with respect to market participants' ESG impact that is becoming relevant outside of the ESG debt financing arena, and companies looking to raise debt should also take this into account when considering their appetite for ongoing ESG reporting.

7. Adopt a jurisdiction-specific financing strategy.

There is no central regulator or authority overseeing ESG financings, and as a result, market practice in the sector has to date tended to be driven by voluntary guidance issued by industry associations with overlapping jurisdiction. For example, ICMA has issued the Green Bond Principles and the Social Bond Principles, which have largely been adopted by the European market as cornerstone guidelines. These principles comprise four basic requirements: (i) use of proceeds with clear environmental or social benefits, as applicable; (ii) the process for project evaluation and selection; (iii) management of the net proceeds; and (iv) ongoing reporting (see "*Consider ongoing disclosure and reporting obligations*" above). The Green Bond Principles and Social Bond Principles also set forth the requirements for a second party opinion, which is typically provided by an entity such as Sustainalytics or CICERO (see also "*Understand the ratings process*" below). Additionally, the Climate Bonds Initiative has introduced the Climate Bond Standards for climate bonds (as opposed to green bonds), and certain stock exchanges (for example, in Luxembourg and Ireland) now have separate green bond segments.

Regulatory authorities are also more frequently stepping in to issue their own guidance and, in some cases, mandatory rules. To date, European regulators have been far more prescriptive than their North American counterparts in this respect. On the whole, market practice is therefore somewhat divergent across jurisdictions, and careful thought should be given at the outset of the process as to the specific regulations, principles and guidelines to which a particular ESG financing will or ought to be subject. Market participants should also be expected to have varying degrees of familiarity with ESG finance products depending on where they are based—ESG debt financings have boomed most notably in Europe, with North America and Asia-Pacific on a recent upswing, but still lagging behind. Both the applicable ESG regulatory overlay and target market should therefore be given due consideration during the initial planning stages of any ESG debt financing transaction.

8. Understand the ratings process.

As with any leveraged finance transaction, engaging with the rating agencies early on and obtaining a credit rating is a key part of the overall process. In an ESG debt financing, issuers and borrowers will want to keep in mind two key ESG-specific aspects to the ratings workstream: first, that ESG considerations are factored into primary credit ratings, and second, that specialized ESG ratings can be obtained by dedicated ESG ratings firms.

Each of the "big three" rating agencies has, for some time, included ESG factors in their credit ratings methodologies as part of a more holistic assessment of an issuer's or borrower's overall creditworthiness. However, some of these agencies have reiterated as recently as this year that ESG considerations are set to play an increasingly important role in credit quality determinations as the financial impact of ESG issues becomes clearer.

Separately, debtors can also obtain specialized ESG ratings from bespoke ESG data providers such as MSCI and Sustainalytics (though some of the "big three" rating agencies are also looking to move into this space). Broadly speaking, these ratings represent a company's exposure to, and ability to manage and respond to, ESG-related risks relative to its peer group. However, a lack of transparency and consistency in scoring methodologies

1 Climate Bonds Initiative (2019), Post-Issuance Reporting in the Green Bond Market, available at: https://www.climatebonds.net/files/reports/cbi_post-issuance-reporting_032019_web.pdf.

between specialized ESG ratings firms has made it difficult for debtors and investors alike to interpret the ratings they issue. Regardless, given increasing investor focus on ESG performance, we expect ESG factors to continue to be given substantial weight in the primary credit ratings process and for bespoke ESG ratings to be more frequently sought and issued in connection with ESG debt financings.

9. Know your investor base (and develop an effective marketing strategy to reach investors).

Understanding at the outset of the transaction where investor demand lies for particular ESG finance products will allow the company and its advisors to structure a deal that is best set up for success. What are the key ESG drivers from the investors' perspective, and what onward disclosures might those investors be required to make? This is becoming an increasingly important part of the equation given that much of the investor community will in the near future be required to make detailed disclosures on how their investment strategy and portfolio align with ESG objectives. This ongoing shift is partly the result of upcoming revisions to the regulatory framework applicable to financial institutions and major corporates (for example, the EU Taxonomy Regulation and the Sustainable Finance Disclosure Regulation), and partly due to increased pressure from investors' own stakeholders. For certain sectors of the investor community, becoming a signatory to the United Nations Principles for Responsible Investment ("**UNPRI**"), which carries with it certain disclosure expectations, is increasingly the norm.

For these reasons, investors will in the future expect issuers and borrowers to be able to articulate exactly where their debt instruments fit within ESG codes such as the EU green taxonomy or the UNPRI. Understanding how to use regulation and international or industry codes to the best advantage possible can therefore generate rewards for issuers and borrowers that are engaging in conversations with, or marketing to, prospective investors.

10. Engage experienced advisors.

As ESG financings become more common, it will be critical for borrowers and issuers to engage transactional advisors with the right ESG experience to facilitate best execution. Many ESG financings now benefit from financial advisors serving in more highly specialized roles, such as "sustainability coordinator" or "green structuring agent", the primary function of which is to assist the borrower or issuer with the development of its applicable ESG targets and advise on other ESG-specific aspects of the transaction. Careful consideration should similarly be given to the legal advisors brought on board. ESG financings require the engagement of legal counsel with equally robust ESG-specific leveraged finance and regulatory expertise. Baker McKenzie's leading, multi-disciplinary sustainable finance practice group is comprised of lawyers with transactional and advisory experience in ESG financings across a wide range of finance products—please visit our **website** for more information.

Conclusion

ESG debt financings have become mainstream. Investors are seeking to fill a growing proportion of their portfolios with ESG-friendly investments, and this continues to encourage the development of a diverse array of creatively-structured ESG debt products. As a result, the market for ESG debt financings has never been more accessible. With the right financial and legal advisors, companies from any industry and in any jurisdiction can successfully execute their own ESG debt financing and tap this ever-expanding corner of the market.

TO SIGN UP TO RECEIVE OUR NEWSLETTER, PLEASE CLICK HERE

TRANSACTIONAL POWERHOUSE

Leading and closing three deals a day

CONTACTS

Rob Mathews
Partner | London
robert.mathews@bakermckenzie.com

Caitlin McErlane
Partner | London
caitlin.mcerlane@bakermckenzie.com

Adam Farlow
Partner | London
adam.farlow@bakermckenzie.com

Megan Schellinger
Partner | London
megan.schellinger@bakermckenzie.com

Samantha Greer
Associate | London
samantha.greer@bakermckenzie.com

Maxim Khrapov
Associate | London
maxim.khrapov@bakermckenzie.com