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Trade Finance Quarterly Insight

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Trade Finance Quarterly Insight

Welcome to the December edition of this quarterly publication that includes a variety of legal and market focused articles on current topics of interest in the world of trade finance.

In our last edition, COVID-19 was the inevitable link between the articles we featured. In this edition, we bring into focus three major topics that are set to play their part in the global economic recovery process - technology, the transition to risk free rates and the role of environmental, social and governance (ESG) criteria in the financial markets.

In the first of three articles, we examine how lenders can better protect themselves from fraud, including a particular look at the prospect of employing ever developing digitalised tools to do so. This topic is particularly poignant in light of this year's collapse of Agritrade and the subsequent accusations of nefarious practices. In the second article, we aim to find a path through the world of LIBOR and the transition away from the benchmark to risk free rates - this subject is set to be a key feature of global financings in the coming 12 months and beyond. In the article,

the authors take the opportunity to highlight some of the specific issues and concerns this transition will raise for trade financing arrangements and how they might be addressed. Finally, we tackle the rapidly-growing and evolving role of ESG in finance. We examine the products that are available, how they might be utilised for the benefit of all parties and what the future of their development might look like.

In addition, we introduce what will become a regular feature of the publication in the form of a Sanctions and Export Controls update page with a link to the Baker McKenzie blog of the same title.

As always we hope that you enjoy this edition of Baker McKenzie's Trade Finance Quarterly Insight and invite you to reach out to any of the contributors or indeed anyone else in the team (please see enclosed Key Contacts) should you wish to discuss any of the issues covered in this edition or have any other trade finance related queries.

Contents

Commodities Fraud and Trade Finance Digitisation



Editor Highlights

- Multiple, and varied, instances of fraud have been uncovered in the commodity finance space in recent months, and this has impacted lenders' appetite to continue their operations.
- The risk of fraud can never be fully mitigated, but transaction structuring techniques and due diligence at the outset in conjunction with ongoing monitoring can assist the parties to prevent fraud, or at least detect it earlier.
- Digitisation of trade finance may play a big part in reducing fraud, but progress remains slow.

The casualty list of commodity traders continues to mount this year, and with coronavirus instigated lockdowns continuing in many major trading territories causing significant disruption to international commodity trading, it is possible further traders will discontinue their operations.

When lenders and insolvency practitioners probe the reasons for the collapse of renowned and globally recognised commodity traders, it has not been uncommon in recent times for nefarious practices to be uncovered. ING Bank claimed to have identified "strong evidence" of "massive, premediated and systematic fraud"

in an affidavit submitted earlier this year to the Singapore courts in connection with the insolvency of Agritrade International,¹ while Commerzbank alleged coal it financed did not exist.² Similarly, HSBC claimed that ZenRock financed the same cargo of oil through multiple banks and Hin Leong sold products that were held as collateral for its loans.³ Less recently, but perhaps more famously, Dezheng Resources was found to have fraudulently pledged the same warehouse receipts issued at the port of Qingdao multiple times to various banks.

But how can lenders better protect themselves from fraud? And how do traders reassure their lenders that their operations are being conducted honestly, prudently and in compliance with applicable laws? The risks of suffering losses arising out of dishonest behaviour can never be fully mitigated, but steps can be taken to limit the ability of perpetrators to take fraudulent action, or to reduce losses by ensuring that malpractice is uncovered at the earliest opportunity - it is in the interests of both traders and their financiers to identify best practices and to

ensure these are followed. With reports that BNP Paribas and ABN Amro have discontinued their commodity finance desks within the last few weeks,⁴ unless greater comfort can be offered to the market by commodity traders it will be increasingly challenging for them to secure finance at the competitive prices enjoyed today.

Due diligence and monitoring: the amount of due diligence and monitoring a lender carries out will be a commercial decision made after the perceived risk is weighed against its impact on the economics of a trade. Different frauds are uncovered through different diligence: for example, physical inspections will counter the risk of multiple warehouse receipts being issued; diligencing a purchase contract with the trader's counterparty may prevent the financing of fictitious cargoes, whilst a careful review of document presentations may uncover seal or signature forgeries or anomalous content. Independent third party scrutiny of borrower certifications may uncover inaccuracies, but in most cases it will be challenging to ascertain whether the inaccuracy of information provided to lenders is attributable to honest mistakes or attempted fraud. This is particularly relevant to borrowing base financings, where large amounts of information are submitted to lenders on a regular basis and there is a clear advantage to be gained by the borrower in inflating the value of its assets.

1 <https://in.reuters.com/article/us-agritrade-international-banks/banks-accuse-singapore-commodity-trader-agritrade-of-massive-fraud-idINKBN20T1E4>

2 <https://www.straitstimes.com/business/companies-markets/collapse-of-singapore-commodity-firm-agritrade-leaves-lenders-exposed>

3 <https://www.ft.com/content/28356e03-1ef9-46ab-aa08-8751687e146d>

4 <https://www.ft.com/content/a61cb821-edaf-41b5-b7dd-f667f3eab81b>

Internal practices: just as banks instigate and follow internal policies and procedures to deter fraud by their employees and to assist in their identification by clients and colleagues alike, banks should consider requesting their clients adopt similar policies. Such clients should carefully consider complying with their lenders' requests, although a balance will need to be struck between the benefits that access to a greater number of lenders brings versus the administrative burden of following such policies, especially where different lending groups impose different obligations. Hotlines to report suspicious behaviour and whistleblower protections, block leave and mandatory compliance training have been commonplace across banks for a number of years, and their implementation by traders as a condition to funding could be easily requested by lenders. And policies already in place must be followed - it is notable that Phoenix Commodities' financial difficulty was attributed to disastrous hedging trades executed by a rogue trader overreaching his authority. As one of our clients put it: "Policies and procedures only work when they are adhered to".

Documentation and structuring: the protections lenders can introduce into their documentation will vary according to the financing they are offering. Where a lender is relying on another party to scrutinise documents presented to it (e.g. bills of lading or warehouse receipts) on its behalf, what standard of review will be carried out? Should sellers be required to acknowledge the revised payment terms added to each invoice financed by the bank? Lenders may want to specify a list of approved third parties involved in the trade such as warehouse operators,

warehouse inspectors and stevedores. Ideally, transactions should be structured to minimise opportunities for the borrower, or its employees, to commit fraud, for example by having offtake proceeds arising out of the commodity that is financed being paid directly to the financier, and by requiring countersignatures from interested third parties where practicable. It is important transactors make the most of the protections afforded by well-drafted documentation and thorough structuring - a senior vice president at a leading commodity trade finance bank warned us that "market practitioners tend to relax documentation standards by adopting weaker structures, with passage of time setting bad precedent".

Digitisation: commodity finance's reliance on paper leaves transactions vulnerable to fraud. Bills of lading, warehouse receipts, invoices and sales contracts can be forged or duplicated. The adoption of electronic documents would speed up and simplify commodity transactions, and a centralised and secure economic ecosystem could reduce the incidence of fraud. Hindered by a lack of common standards and protocols, however, the movement towards digitisation has until recently been slow-paced. In 2018 the International Chamber of Commerce commissioned a survey on the enforceability of electronic bills of lading under the laws of Brazil, China, England, Germany, India, the Netherlands, New York, Russia, Singapore and UAE. The report concluded that the "legal status of eB/LS is still very unclear"

and noted that only New York law expressly supports their use.⁵ Meanwhile, the UNCITRAL Model Law on Electronic Transferable Records, which was adopted in July 2017, has so far been enacted only in Bahrain.

Recently, the adoption of digitisation has gathered pace, spurred on by a desire to streamline trade finance and to mitigate against the fraudulent practices brought to renewed focus in recent months. Contour, a company in Singapore that uses blockchain technology to simplify trade finance, launched into live production in October 2020 following a period of testing with over 80 banks and corporates in more than 17 countries.⁶ Owned by eight shareholder banks (Bangkok Bank, BNP Paribas, CTBC, HSBC, ING, Standard Chartered, SEB and Citi), Contour's live offering utilises blockchain technology to automate processing of letters of credit, reducing processing times by up to 90% during testing. The company intends to supplement its offering with further modules, with bank guarantees the next product to feature.⁷

Another blockchain-based offering, komgo, launched in September 2018 and counts some of the leading financial institutions and commodity traders in the commodity finance

5 <https://iccwbo.org/content/uploads/sites/3/2018/10/the-legal-status-of-e-bills-of-lading-oct2018.pdf>

6 <https://www.contour.network/about>

7 <https://www.gtreview.com/news/fintech/exclusive-contour-goes-live-making-blockchain-based-trade-finance-a-reality/>

space as backers. It offers a streamlined KYC process and a digital marketplace and multiparty communication platform. Its “Trakk” service tackles fraud by allowing users to stamp and authenticate digital documents, creating an invaluable audit trail.⁸

In October 2020, DBS Bank and Standard Chartered announced that they were leading 12 other banks in creating a digital Trade Finance Registry proof-of-concept that utilises blockchain technology to mitigate against duplicate financing.⁹ Supported by Enterprise Singapore, the project aims to tackle duplicate financing by allowing participant banks to verify whether financing has been sought with other banks using particular title instruments, without sharing sensitive information.¹⁰

While such developments are promising, they will only be successful with sufficient buy-in from institutions, trading houses and lawmakers. Whether digitisation succeeds will depend on support by key stakeholders, the willingness to embrace change and the widespread adoption of a limited number of platforms by consolidating what seems today to be a fragmented digital offering.

⁸ <https://komgo.io/>

⁹ <https://www.sc.com/en/media/press-release/weve-joined-dbs-to-lead-industry-workgroup-to-develop-trade-finance-registry-pilot-to-enhance-trade-transparency/>

¹⁰ <https://www.gtreview.com/news/asia/singapore-banks-take-on-trade-finance-fraud-with-blockchain-registry/>



The risk of fraud is ever present in complex commodity finance structures - lenders can protect themselves by good documentation and thorough diligence, but increasing digitisation also offers the exciting prospect of reducing fraud significantly.



Nick Tostivin, Partner



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LIBOR Transition and Trade Finance



Editor Highlights

- The widely-used LIBOR benchmarks will be discontinued at the end of 2021 and all participants in trade finance should accelerate the pace of transition to alternative rates despite the additional challenges posed for some products.
- EURIBOR will remain available into 2022 so euro-based products will be unaffected (for now), fixed rate or central bank/prime rate financings may be suitable alternatives for some customers and there are increasingly realistic prospects that much-needed forward-looking term rates will become available for US Dollar and Sterling loans by the first half of 2021.
- Market participants should consider the available documentary solutions for new and legacy products and, where feasible, seek to avoid reliance on legislative solutions proposed in the US, the UK and the EU which may clash and create additional problems.

As we approach the end of 2020, the much anticipated discontinuation of all London Interbank Offered Rates (LIBORs) at the end of 2021 is looming. The sheer volume of alerts, articles, guidance, recommendations and checklists issued by regulators, trade associations and professional advisers on an almost daily basis can seem overwhelming. Many exhort lenders, borrowers and other affected parties to “check their contracts”, “consider alternative rate options”, “make transition plans” and to “act now” as time is fast running out. These are laudable and sensible suggestions but LIBOR users now need to know what they should be doing in practice, how their loan documentation will differ and when they need to make this happen.

It is clear that the loan markets are lagging behind other financial instruments (such as bonds and derivatives) in the move away from LIBORs. The Loan Market Association (LMA) tracker of all publicly disclosed loan agreements where interest is (or will be) charged by reference to near risk-free rates (RFRs) includes a grand total of four syndicated facility agreements (all revolving credit facilities for multinational corporations with their relationship (club) lenders) and 14 bilateral facility agreements. Of the bilateral facility agreements, only one is a trade finance facility.

The issues holding back transition in the loan markets in general, and in the trade and export finance sector in particular, are well documented. RFRs have been identified by the working groups in the five LIBOR currencies (Secured Overnight Financing Rate (SOFR) for US Dollars, Sterling Overnight Interbank Average Rate

(SONIA) for Sterling, Euro Short-Term Rate (€STR) for Euro, Swiss Average Rate Overnight (SARON) for Swiss Francs, and Tokyo Overnight Average Rate (TONAR) for Japanese yen) as suitable alternatives to LIBORs. However, operationalising backward-looking overnight rates for use in longer-term loans is a headache.

The main solution proposed for using RFRs in loan agreements involves compounding an RFR over a period of time that is shifted backward or lags the interest period by a few days.

In sovereign lending and emerging markets transactions, where governmental sign-off and exchange control licences may be required before a loan can be authorised or before local currency can be exchanged into US Dollars, as a practical matter, much longer notice of the exact interest payment due may be required. While forward-looking term rates (based on derivatives of those near RFRs) are strongly desired by many loan market participants, for trade finance structures, such as receivables purchase financing and traditional discounting of trade instruments, which rely on the full amount of interest being ascertainable at commencement (and applied as a deduction from the purchase price), the advance notice and certainty of costs that LIBORs provide is essential. In some jurisdictions, charging compounded interest can be problematic (in particular in certain emerging market jurisdictions). Bodies such as the International Chamber of Commerce (through its working group on IBOR demise) and the Bankers Association for Finance and Trade have made representations to the various LIBOR currency working groups to press the urgent case for forward-looking term rates for trade and export finance.

Working groups in each of the LIBOR currencies are adopting different approaches on transition issues and deviation between different types of financial products is evident. For example, for syndicated business loans, the Alternative Reference Rates Committee (ARRC) has recommended the use of daily simple SOFR, the Working Group on Sterling Risk-Free Reference Rates (RFRWG) has suggested compounded in arrears SONIA without observation shift, and the National Working Group on Swiss Franc Reference Rates (NWG) has settled on compounded in arrears SARON with observation shift. While the overall economic impact of the different approaches may be small (particularly over shorter terms and in low interest rate environments), implementing internal systems that can accommodate all permutations will be burdensome. Meanwhile, the derivatives market will use RFRs compounded in arrears with observation shift for all currencies, creating further potential for hedging mismatches with linked-loans.

For both US Dollars and Sterling, work continues on producing useable forward-looking term rates based on SONIA and SOFR, respectively. This is not the case for Swiss Francs. Moreover, for euros, LIBOR is little used compared to the forward-looking term rate EURIBOR, which will continue into 2022 and beyond (with no immediate plans for its discontinuance).

Alongside the intensifying calls by regulators to actively transition away from LIBORs, legislative solutions to the problem have been tantalisingly proposed in the UK, the US and the EU. However, the approaches mooted overlap and contradict. In the US, draft

legislation has been floating around since March 2020 that would impact New York law contracts and US Dollar loans. In the UK, the legislation would not directly amend contracts but would give the Financial Conduct Authority (FCA) additional powers to require the methodology for calculating LIBORs in all currencies to be changed (most probably to rates based on the designated near RFRs plus a credit adjustment spread). The EU plan is for all contracts (whatever the governing law) to which an EU financial institution is party to be amended to an identified suitable replacement rate. While the exact scope of these legislative solutions remains unclear, it is apparent that there is little joined-up thinking globally. If all these go ahead (which is far from certain with other issues, such as the coronavirus and Brexit, occupying legislatures), a New York law multi-currency facility agreement with an EU bank lender could be in scope for all of the 'solutions', raising a number of conflict of laws considerations. Given that one of the principal aims of regulators, such as the FCA, is to ensure financial stability, it is hard to see how these proposals will assist with orderly transition.

The prospects for LIBORs to continue into 2022 (and beyond) will become clearer in the next few months. There has been some thought that the only thing holding the FCA from officially announcing the end date for LIBORs is the much-anticipated and much-delayed launch and adoption of a supplement to the ISDA 2006 Definitions (and ISDA Protocol that enables incorporation of those supplemental terms into existing derivatives contracts), which will replace references to LIBOR in relevant derivatives contracts with references to compounded in arrears RFRs plus an

agreed credit adjustment spread. One of the last hurdles for that ISDA launch — obtaining a green light from the US Department of Justice — was overcome on 1 October 2020 and the protocol was launched on 23 October 2020 and will have an effective date of 25 January 2021. However, the UK's tough legacy legislation, which is intended to give the FCA additional powers to ensure an orderly wind-down of LIBORs, is still making its way through the UK parliamentary process and it would appear churlish for the FCA to make any announcement before those new powers are secured. Speculation also continues on whether any FCA announcement will cover all LIBOR currencies and tenors or whether there may be earlier termination of the less-well used pairs with, for example, three and six-month US Dollar continuing for a longer period. This belief has recently been reinforced by ICE Benchmark Administration's (IBA) announcement on 18 November 2020 of its intention to consult on cessation of the publication of LIBORs after 31 December 2021 in all currencies except for US dollars. Any reprieve for US Dollar LIBOR may well be short-lived. In addition, as already noted, the FCA may allow at least some 'LIBORs' to continue after they have become unrepresentative by exercising its powers under the proposed UK legislation to change the methodology for calculating LIBORs.

Finding a path through all the noise and confusion will tax us all. For the time being, lending in euros on the basis of EURIBOR remains a viable option. The Working Group on Euro Risk-Free Rates will consult this month on fallbacks for EURIBOR based on €STR (both backward and forward-looking rates), applicable credit adjustment spreads and the trigger events for such

fallbacks; however, any requirement to actively transition away from EURIBOR will come at a later date and market participants will surely benefit from the experience of LIBOR transition. For Sterling, forward-looking term rates based on SONIA are already being produced in beta form by three providers, with the hope that at least one of these will be authorised for use in transactions by early 2021. The RFRWG has recognised trade finance as one of the special-use cases where “Term SONIA” will be an option. In the US, the ARRC has recently tendered for providers of Term SOFR with publication expected in the first half of 2021. The prime concern for US Dollars is whether there will be sufficient deep liquidity in the underlying SOFR derivatives markets to allow regulators to authorise use of a “Term SOFR” for actual transactions. Nevertheless, in the best-case scenario, there will be forward term-rate options for Euro, Sterling and US Dollar by the middle of 2021. They will operate in the same manner as LIBORs and, therefore, from both the operations and the documentary perspective, little change will be required apart from consideration of a credit adjustment spread. However, what if there is a delay or other problem with forward-looking term rates? In summer 2020, the RFRWG suggested that lenders could consider an arrangement whereby a loan switches to a forward-looking term rate, if available, and to an alternative reference rate, such as a central bank or prime rate, if not. It would also be sensible to consider alternative structures; the most obvious is a last reset (or compounded in advance) approach where the backward shift or lag over which the relevant RFR is compounded is a whole interest period. This gives certainty of costs and

advance notice of payment in the same way as LIBOR but the mismatch between the interest period and calculation period means the rate used will be stale and will create the opportunity for a basis risk with any related hedging. Other possibilities include fixed rate financings (although, within the lending institution itself, there may still be interest make-up agreements to consider). The odds on an extension for USD LIBOR into 2022 have also increased following IBA’s recent announcement. This may encourage some to ease off on transition in USD-denominated markets but, ultimately, USD LIBOR will too end in the near future.

Multilateral development banks, such as the International Finance Corporation (IFC), European Bank for Reconstruction and Development and the African Development Bank, are actively engaging with the LIBOR transition process. Each has tapped the debt capital markets with SONIA and SOFR bond issuances over the last few years and the IFC is seeking to collaborate with other multilateral development banks and development finance institutions on best practices around LIBOR transition. We hope this will bear fruitful results and aid commercial lenders and others operating in their spheres of work. It is apparent from the IFC’s budget document for FY 2021 that much work is ahead; it notes that amendments to LIBOR-referencing syndicated loans alone will require negotiations with approximately 150 other lenders in addition to the diverse borrower base.

In September 2020, the LMA published an exposure draft of its multicurrency investment grade facility agreement as a “switch” agreement; the interest rates will initially be based on LIBORs, EURIBOR or other IBORs but then, on a per currency basis, will “switch” to interest rates based on compounded in arrears RFRs when a trigger event occurs. In the US, the Loan Syndications and Trading Association (LSTA) also issued a daily simple SOFR concept credit agreement. At this stage, neither of these documents represents accepted market practice — because there is virtually no market practice at present — and significant issues (such as credit adjustment spreads, cost of funds fallbacks and break funding costs) remain open. This is true even in the relatively “plain vanilla” investment grade corporate loan sphere. The RFRWG has recommended that, from the end of September 2020, all new Sterling loans that reference LIBOR must include either a pre-agreed process for renegotiation (away from LIBOR) or pre-agreed conversion terms. The “switch” agreement represents the latter. They have re-iterated that this deadline equally applies to trade finance products. What is more likely to be seen in trade and export finance is the LMA’s recently revised “replacement of screen rate” clause (which is intended to address the RFRWG’s other option of a pre-agreed process for renegotiation). While the availability of Term SOFR and Term SONIA remains unclear, any (widespread) adoption of “switch” agreements or facility agreements based on RFRs from inception appears unlikely in this sector. Added to the uncertainty for US Dollar products is whether or not USD LIBOR will be available for a more extended period of time and, indeed, there is still open debate among banks in

the US as to whether SOFR is the right basis for cash products at all (with a number of credit-sensitive benchmarks and add-ons in development or already available that may ultimately gain market traction). A “replacement of screen rate” clause allows the parties to continue to leave their options open as market conventions and consensus develop but will, of course, create further legacy transactions that will require active transition prior to the end of 2021. The revised “replacement of screen rate” clause imposes an additional obligation on the parties to negotiate in good faith to agree suitable amendments to a facility agreement and allows the parties to choose a timetable for commencement and finalisation of those negotiations. However, as can be seen from the negotiations between the UK and the EU relating to the UK’s exit from the EU, an agreement to negotiate in good faith does not require parties to actually agree to anything.

While the transition away from LIBORs poses undoubted challenges, it also offers the prospect of financing transactions based on more solid and transparent foundations and possibilities for new ways of conducting business free from constraints of past practices. Collaboration between lenders, borrowers, export credit agencies and regulators will be needed throughout 2021. Each risk-free rate transaction will provide a learning opportunity for those involved and the wider market and help coalesce market practice.

“

LIBOR transition is moving up the agenda of lenders and corporates. With its demise at the end of 2021 increasingly certain, the trade finance community will need to accelerate adoption of alternative rates and continue to lobby for the tools it needs to make this a success.”

Nick O’Grady, Partner

STOP PRESS: On 30 November 2020, In a set of coordinated statements, ICA, the FCA and the principal US banking regulators announced plans that would extend the period during which panel USD LIBOR quotations for the most widely used tenors would be made available until the end of June 2023. This would effectively provide a period for legacy USD LIBOR transactions to use LIBOR quotations after 2 January 2022 (when LIBOR is expected to cease for other currencies).



Please stay up to date with LIBOR transition developments at [Baker McKenzie’s LIBOR Hub](#).

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Top Ten Tips for ESG Debt Financings



Editor Highlights

- ESG financing may still be in its early days but it is developing at a rapid speed across all types of financial product and should be considered relevant by all companies across industries.
- Borrowers and lenders alike should be paying immediate attention to ESG financing, not just for the obvious altruistic reasons but because action is being demanded by stakeholders, governments and other authorities.
- ESG financing is here to stay, as urgent environmental, social and governance drivers push the agenda across all industries and jurisdictions finance initiatives will be needed to fund ESG-related growth into the foreseeable future and beyond.

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 article 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.

FACT: *ESG finance is at the top of the agenda for many governments* - the UK government recently announced that post-Brexit it will make the Task Force on Climate-related Financial

Disclosure (TCFD) aligned disclosures fully mandatory across the economy by 2025, which goes well beyond the ‘comply and explain’ approach currently followed; and it has pledged to implement a green taxonomy like that of the EU.

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.

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

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.

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-compliant. 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. All financial institutions participating in these financings, in a range of capacities, 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 (that can find their grounding in the Sustainability-linked 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”)) on which further guidance notes were recently issued) 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 debt 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 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 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 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 learn more about ESG debt financing and access our newly launched podcast series, please contact a member of our team.

“
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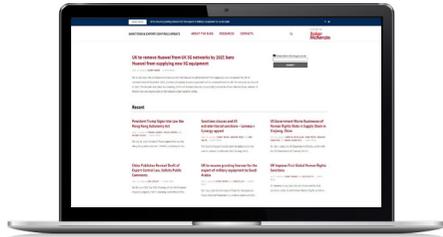


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Additional Insights



LIBOR Transition Hub

In July of 2017, Andrew Bailey, the chief executive of the UK Financial Conduct Authority (FCA), announced in a speech that after 2021 the FCA would no longer use its power to compel panel banks to submit rate information used to determine the London Interbank Offered Rate (LIBOR). Mr. Bailey encouraged the market to develop robust alternative reference rates to replace LIBOR. Baker McKenzie is pleased to provide expert guidance on LIBOR transition. Please click [here](#) to explore our LIBOR Hub.



BREXIT: What it means for your business

The Brexit transition period deadline of 31 December 2020 is fast-approaching. The implications of either a trade deal or a “no-deal” between the UK and EU will constitute a major change for any company that has operations — directly or indirectly — in the UK as well as in the EU. Whatever the outcome and wherever you are in your Brexit planning, we provide you with the resources and support to analyse and understand the various potential outcomes of Brexit on your business, and how to best mitigate the potential risks posed and capitalise on new opportunities that may arise. Please click [here](#) to find out more.



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