**STEPHENSON HARWOOD'S COP26 INSIGHTS SERIES**


# The LMA's green, sustainable and social loan principles – what more can be done?

COP26 is billed as a significant milestone for the transition to a sustainable future. The objective for the private finance work for COP26 is stated to be simply: "*ensure that every professional financial decision takes climate change into account*".

While the stated objective may be simple, achieving that objective will involve considerable international cooperation between the public and private sectors to put the right frameworks in place.

The Loan Market Association ("**LMA**") have already taken a leading role in helping to progress this. Their Green Loan Principles ("**GLP**") were published in 2018, closely followed by the Sustainability-linked Loan Principles ("**SLLP**") (2019). More recently (in 2021) they published their Social Loan Principles ("**SLP**") (2021). Please see the attached article Sustainability-linked loans and green loans in the real estate finance market (shlegal.com) for further guidance on the LMA's green and sustainable loan principles. Please also see the following link to the LMA's website to see the principles in full - Documents (lma.eu.com).

There has been a great deal of industry interest in these principles and they have undoubtedly been well received. One of the main aims of the principles was to help encourage the UK finance industry to place a higher emphasis on the green and sustainable credentials of potential loans – this is certainly being achieved.

In this article we look at how further developments in the application of these principles could help to drive additional positive changes in the lending industry and achieve the aims of the COP26 by building a framework for the financial sector around reporting, risk management, returns and mobilisation.

## 1. Appreciating that non-compliance with the LMA principles does not mean the loan lacks environmental or social benefit

Achieving an LMA compliant green, sustainable or social loan is considered the "gold standard" in its field, and serves as a very strong indicator that the loan has genuine and meaningful green/sustainable/social credentials. However, many loans will still have these genuine and meaningful credentials even if they fall short of, or do not neatly fit within, the LMA's strict requirements.

For example, in order to comply with the LMA's SLLP the borrower must obtain independent and external verification of their performance level against each sustainability performance target. This is a requirement recently introduced by the LMA in an effort to protect the principles against sustainability green-washing, but can have the effect of significantly adding to the borrower's costs. Given margin reductions are typically not huge (often c.10 bps), there is often a reluctance to allow these costs savings to be used up by third party verification costs. If a borrower has the necessary expertise and processes to carry out the verification itself robustly and honestly – and if this is done in a transparent way – lenders may be happy to allow this. This would not detract from the sustainability benefits of the loan and the loan may even have stronger sustainability credentials than an LMA compliant sustainability-linked loan. Nonetheless the absence of third party verification would mean it could not be badged as being fully LMA compliant.

Another example we have come across of a loan having all the correct green credentials but nevertheless failing to fit into the LMA's GLP arose when we were asked by a client to consider whether a proposed loan would be compliant with the GLPs. The proposed loan was to be used to redeem investors in an existing green sub-fund, such that their funds are then re-invested in a new green sub-fund (the proposed borrower). Whilst this loan would clearly have strong green credentials (it is investing in a green sub-fund), the GLP's "purpose" and "reporting and monitoring" requirements were unlikely to be met. The purpose of the proposed loan to redeem units in a green sub-fund does not neatly fit into the GLPs, and it is difficult to see how the LMA's reporting and monitoring requirements could be met given the distance from the loan to the actual green projects.

Falling short of being able to label a loan of this nature as "LMA compliant" does not, of itself, mean that it cannot still truly and legitimately be described and marketed as being a green, sustainable or social loan. The loan may well have many of the characteristics required by the LMA principles and be of real and genuine benefit to the environment and society. Provided this is the case, there is no need to fear accusations of green-washing and it would still be perfectly correct and legitimate to promote the loan as being a green, sustainable or social loan.

## 2. Move towards industry standard certifications

Being able to measure a borrower's compliance with the green, sustainable or social criteria of the loan is a key requirement of all of the LMA's principles.

As such, a question often asked by both our lender and borrower clients is what criteria should be used for assessing whether the loan has met its green or sustainability targets. At present there is a huge range of different criteria and certification standards. The lack of industry standard measures and certifications can create uncertainty and opaqueness and could even lead to unintended green-washing.

Additionally, even certifications which are relatively well known can attract differing opinions with regard to their suitability for measuring a green or sustainable loan. By way of example, whilst EPC certificates are commonplace, they are not uniformly considered the best measure of a building's energy efficiency as they are really a measure of a building's "design intent" which may not necessarily correspond with the true energy efficiency of the building.

However agreeing industry standard certifications and measures are considered a key step in progressing towards more widespread application of the LMA's principles. We anticipate that as the green and sustainable loan market matures further, particular measures and certifications will become established and "industry standard". For real estate, one of the most successful voluntary certifications, LEED – which estimates that they certify over 1.85 million square feet of construction space every day – provides an optional green building ratings system, with a variety of different ratings systems targeting new projects, existing projects, interior design and even domestic properties. Similarly, BREEAM provides a sustainability assessment method that can be applied worldwide to rate developments, refurbishments and operations based on their overall ESG characteristics. Both these measures are considered likely to lead the way, not least given their global applicability. Both LEED and BREEAM are used all around the world and therefore provide a global benchmark which can, in particular, help larger multi-national companies to assess their ESG credentials across all their branches in a uniform way, rather than having individual ESG compliance methods that are only comparable on a national level.

## 3. Tightening of the voluntary frameworks and standards

It seems clear from the stated COP26 goals that certain voluntary frameworks and standards are likely to be tightened up and become mandatory in the future.

Building a private finance system for zero – priorities for private finance for COP26 stresses the importance of a reporting framework. The paper talks about implementing a common framework built on the Taskforce for Climate-related Financial Disclosures (**TCFD**) recommendations. As it becomes obligatory for borrowers to comply with various climate-related and other ESG-related financial disclosures, this increased transparency and consistency will in turn inevitably drive and shape lenders' due diligence and ongoing monitoring requirements, as well as making it easier for a lender to measure a borrower's compliance with targets, goals and metrics during the life of a loan.

New rules usually add a layer of unwanted bureaucracy for a lender. However, a move towards consistent and internationally-recognised frameworks for lending in the "green" and "ESG" space could well serve to make lenders' lives easier.

Although we are still some way off this, it is not hard to envisage a not-too-distant future in which it is mandatory to comply with sets of principles similar to those devised by the LMA in order to market a loan as a "green loan", a "sustainability-linked loan" or a "social loan". Lenders and borrowers who are already experienced in working with these principles will be well placed to adapt to any regulatory tightening in this area.

## 4. Speak to Stephenson Harwood

We are advising both lenders and borrowers at all stages of their green, sustainable and social loan journeys. This includes work streams such as:

- discussing with borrowers whether their environmental activities may be suitable qualifying criteria for a green or sustainability-linked loan;
- producing precedent LMA compliant green loan documentation for lenders;
- advising on green and sustainable loan transactions;
- assisting on a project to develop a climate change due diligence questionnaire to be used by borrowers and lenders; and
- running training sessions on all aspects of green and sustainable loans.

Whatever stage in the process you are at, we would be delighted to work with you and help you through the process. Please do get in touch.

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