STEPHENSON HARWOOD

Green Shoots in ship finance:

The rise of the green finance revolution

Introduction

Despite stiff competition from Brexit, LIBOR transition and Covid-19, climate change remains a topic never far away from the news headlines. There is a common acceptance that whilst significant steps forward have been taken in recent years to mitigate the speed and extent of climate change, efforts in this regard need to be significantly accelerated. This is an issue which affects everybody and every industry and there is a very clear need for a unified and cooperative approach in order to address the problem.

The transition to a green economy will play a very important role in this process. Green projects and energy efficient practices often require significant initial (and on-going) expenditure and so the support of lenders is vital. This publication explores the approaches being taken by the ship finance industry in making this transition and sets out views on future steps needed in order to promote even further growth in the green ship finance sector.

I hope you will find this brochure both useful and interesting. If there are any aspects of it you would like to discuss further, or there are any green finance queries we can help with, we would be very pleased to hear from you.

Ian Mace
Global head of ship finance
London

T: +44 20 7809 2653
M: +44 7827353109
E: ian.mace@shlegal.com

Green and sustainable lending

Green and sustainable finance is now an area of focus for both the public and private sector. A key part of this type of financing is to better manage environmental and social risks, take on opportunities that bring both a satisfactory rate of return and environmental benefit and deliver greater accountability.

The finance industry is becoming increasingly proactive in this area. The Loan Market Association ("**LMA**"), in particular, has played a significant role in steering the market and (as has been shown recently by its detailed response in July 2020 to the EU Commission's consultation on the Renewed Sustainable Finance Strategy) it is well aware of the need to demonstrate commitment and support for green and sustainable finance initiatives. As this type of lending is only going to increase and develop over the coming months and years, it is helpful to look first at what is meant by "Green" and "Sustainability Linked" lending.

Green loans and the development of the Green Loan Principles

Loans that require the borrower to use the proceeds for a "green" purpose have been around for many years. However, to help grow the market of green loans, in March 2018, the LMA published the Green Loan Principles ("**GLP**"). The GLP define green loans as any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible "Green Projects". The GLP set out the framework for understanding the characteristics of green loans based around four main components:

- use of proceeds
- process for project evaluation and selection
- management of proceeds
- reporting

The GLP built on the Green Bond Principles ("**GBP**") which were formulated by the International Capital Market Association with a view to promoting consistency across financial markets. The GBP are internationally recognised voluntary guidelines that are aimed at promoting transparency, disclosure and reporting in the green bond market.

Sustainability-linked loans and the development of the Sustainability-linked Loan Principles and Guidance

Recently, the volume of sustainability-linked loans has grown exponentially, outstripping the volume of green loans. The Sustainability Linked Loan Principles ("**SLLP**") (published by the LMA in March 2019) make it clear that sustainability-linked loans are not characterised by the borrower's use of proceeds. Instead, the goal of the sustainability-linked loans is to enable lenders to incentivise improvements in the borrower's sustainability profile by aligning the loan terms to the borrower's achievement of pre-determined sustainability performance targets ("**SPTs**"). Examples of SPTs categories include improvements in the energy efficiency of buildings, reductions in greenhouse gasses, improving a company's environmental, social and governance ("**ESG**") rating and the achievement of a recognised ESG certification.

Sustainability-linked loans are attractive to borrowers who do not operate in the green sector and who do not have the resources or appetite to invest in green projects, but who are beginning to introduce sustainability targets and policies.

In order to promote the development of green and sustainability-linked loans, in May 2020, the LMA produced guidance on the GLP and SLLP to provide market practitioners with clarity on their application and promote a harmonised approach.

Sustainable finance regulation

In June 2020, the EU Commission adopted the Regulation on the Establishment of a Framework to Facilitate Sustainable Investment (Taxonomy Regulation), marking a significant step in the realisation of the EU Commission's action plan on financing sustainable growth. The Taxonomy Regulation introduces an EU-wide classification system of environmentally sustainable activities. The Taxonomy Regulation, together with the Non-Financial Reporting Directive, will require certain financial services firms and large public interest entities to perform an analysis of their economic activities and disclose additional information in their non-financial statements on how these activities are associated with environmentally sustainable targets.

Despite Brexit, the UK government is committed to matching the EU Commission's sustainable growth strategy, which means that the UK will retain the taxonomy framework, including its high-level environmental objectives. However, the disclosure requirements contained in the Taxonomy Regulation only apply after 31 December 2021. Therefore, the disclosure requirements referred to above will not form part of the retained EU law as things currently stand (albeit it remains open to the Government to introduce further legislation to also retain these disclosure provisions and it will be interesting to see if this is a step taken in the future).

Green and sustainable lending in shipping

How prevalent is green/sustainability-led financing?

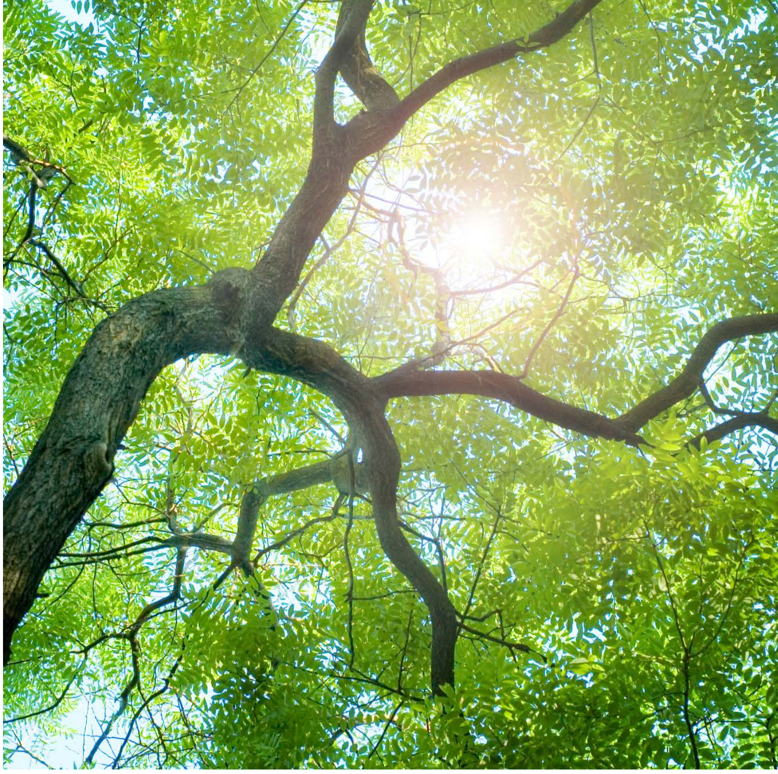
At the time of writing, this is a relatively small but growing percentage of the overall ship finance market (around 10%). The market drivers have mostly been European financiers. In Asia, Japanese banks are getting involved and we expect that other Asian banks will follow.

Examples of how green/sustainability-led financing has been used in shipping.

Green financing – This mostly takes the form of a green tranche within a wider facility or an up-size facility to finance a particular piece of kit for a vessel, such as scrubbers, ballast water treatment systems, propeller cap fins or to cover R&D expenses. Facilities for entirely green purposes have been focused on LNG-fuelled vessels. We expect these to become more prevalent given the significant order book for LNG-fuelled vessels.

Sustainability-linked financing – This has been slightly more common, but still represents a small percentage of deals. Facilities are primarily used as working capital or revolving credit facilities and have been more popular amongst liner companies. The most common target used is the reduction of greenhouse gas emissions at a faster rate than the IMO target.

Green/sustainable bonds – There have been some green bond placements, especially in the New York markets.



Have there been any ship-specific initiatives which could be relevant in the context of green/sustainability-led finance?

New regulations – Green/sustainability-led finance is a by-product of increased environmental regulation on ship owners and operators in the last years. Some key examples are:

- The new IMO global sulphur cap on fuel under MARPOL Annex VI, which has been lowered from 3.5% to 0.5% and entered into force as the IMO 2020.
- The Ballast Water Management Convention, which requires ship owners to implement a BWM plan that enables any international sea-going vessels to manage their ballast water and sediment discharge.
- The new IMO Energy Efficiency Design Index and Plan, which require new ships to comply with minimum mandatory energy efficiency performance levels, increasing over time through different phases and establish a mechanism for shipowners to improve the energy efficiency of both new and existing ships using operational measures such as weather routing, trim and draught optimization, speed optimization and just-in-time arrival in ports.

Poseidon principles – Published in June 2019, these principles establish a framework for disclosing the climate alignment of ship finance portfolios which can then be measured against the IMO's emissions target. At the time of writing, 18 banks representing US$150 billion of shipping loans have signed up. We are yet to see the first set of published results showing fuel consumption data across the relevant banks' mortgaged fleet.

Green Shipping Financing/Guarantee Programme – This €750 million project was launched in 2016 by the European Investment Bank to clean up the industry and to support the financing of new, greener vessels, alongside environmentally friendly retrofitting of existing ships to comply with the new regulations.

Recycling of ships – In May 2009, the Hong Kong International Convention for the Safe and Environmentally Sound Recycling of Ships came into force to ensure that ships, when being recycled after reaching the end of their operational lives, do not pose any unnecessary risks to human health, safety and to the environment. Similar measures were later taken in the EU.

What are some of the upcoming initiatives to look out for?

The Climate Bonds Shipping Criteria - This is expected to be published towards the end of 2020 and will form part of the Climate Bonds Standard. It will provide an assessment process on the low carbon and climate resilient credentials of shipping projects and assets. These Criteria directly link the bond's Use of Proceeds to the ships' energy efficiency and how that will be improved over the duration of the bond.

IFC-GEF Greener Shipping Investment Platform Joint Venture for the Decarbonisation of Maritime Transportation – This will be the first global financing platform focused on decarbonizing the shipping industry. It is aligned with the IMO's Initial GHG Strategy and is expected to have a transformative impact on the shipping sector's climate footprint. This technology-agnostic and private-sector driven platform is intended to act as a financing vehicle to accelerate the creation of a global fleet of low-carbon ships and to ensure transparent and timely knowledge sharing on fuel-saving and low carbon technologies across the shipping industry.

Greenhouse gas tax suggestion for ships – Trafigura, one of the world's largest ship charterers, has proposed a global fuel levy of US$250 to US$300 per tonne of CO_2 equivalent on shipping fuel. The revenue raised by the levy would then be used to subsidise and incentivise low and zero-carbon fuels and subsequently also be used to fund the research and development of alternative fuels. The plan would help the shipping industry meet the IMO's Initial GHG target for the reduction of GHG emissions by at least 50% by 2050 compared to 2008. The IMO has yet to decide whether there will be a mandatory enforcement of the proposed greenhouse gas tax.

Most of these initiatives affect shipowners. What is their actual impact on ship finance lenders?

Investing in greener technologies and lower-emission solutions represents an upfront expense, which means that shipping companies may require additional finance to back research and development initiatives and install equipment that will allow them to comply with the regulations.

At the same time, banks and other financial institutions are increasingly required to justify their investment choices based on sustainability and environmental risk, and public opinion is demanding ever more urgent action on environmental sustainability. As a result, we expect that lenders will be increasingly inclined to finance customers that have set ESG targets as this will allow them to extend green or sustainable finance and improve their carbon rating under the Poseidon Principles.

Important next steps for green/sustainability-led financing to become more common.

At this stage there are no regulations in force which would oblige banks to provide a certain minimum percentage of green or sustainable finance. We expect regulations at the national and European level to address this in due course, perhaps through the granting of financial incentives, such as reduced capital charges for lenders providing certain levels of green or sustainable finance.

More ECA support for domestic yards building new eco-ships would be a good way of incentivising banks and providing comfort in investing in green assets. Another important step would be the development of a commonly accepted concept of green or sustainable finance in shipping to help create a uniform market, to provide more certainty and to avoid "green-washing".

A final important step would be the ability to extend the availability of green and sustainability-linked financing to smaller shipping companies. It may be that government intervention is needed to achieve this.

Dora Mace-Kokota

Partner, ship finance, green finance working group champion
London

T: +44 20 7809 2325
M: +44 7769144915
E: dora.mace-kokota@shlegal.com

Jeffrey Tanner

Senior associate, ship finance
Singapore

T: +65 6622 9653
M: +65 8233 5007
E: jeffrey.tanner@shlegal.com

Pedram Norton

Senior associate, ship finance
Singapore

T: +65 6622 9651
M: +65 9456 6462
E: pedram.norton@shlegal.com

Danae Hosek-Ugolini

Consultant, ship finance
London

T: +44 20 7809 2277
E: danae.hosek-ugolini@shlegal.com

Gregg Johnston

Partner, ship finance
Singapore

T: +65 6622 9663
M: +65 8112 7589
E: gregg.johnston@shlegal.com

Elton Chan

Partner, ship finance
Hong Kong

T: +852 2533 2726
M: +852 9350 9218
E: elton.chan@shlegal.com

Nigel Bowen-Morris

Partner, ship finance
Piraeus

T: +30 210 429 5160
M: +30 695 750 5481
E: nigel.bowen-morris@shlegal.com

Nijoe Joseph

Partner, finance
Dubai

T: +971 4 407 3921
M: +971 50 644 3571
E: nijoe.joseph@shlegal.com

Ian Mace

Global head of ship finance
London

T: +44 20 7809 2653
M: +44 7827353109
E: ian.mace@shlegal.com

www.shlegal.com

STEPHENSON HARWOOD

BD1025-Green finance-1020