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Green shoots:
The rise of the green finance revolution

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Introduction

Despite stiff competition from Brexit 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 to tackling 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 finance industry in making this transition and sets out views on future steps needed in order to promote even further growth in the green finance sector.

Our London finance practice covers the full spectrum of the finance sector so we are well placed to see, and advise on, the continued development of green finance across all types of financings. In this brochure, green finance specialists in each of our capital markets, ship, aviation, rail, leasing and real estate finance practice groups provide their insights into how green financing is currently being used in their specific sub-sectors, and future steps to be taken for it to gain even further traction. Additionally, we are very grateful for the insights provided by our guest contributors:

- **Peter Cosmetatos**, CEO of CREFC Europe who comments on the contributory factors to the growth of this sector and an overview of the role lenders and regulators will play in driving it forward.
- **David Stephens**, HSBC UK's Head of Corporate Real Estate London, who considers reasons why the popularity of sustainability-linked loans is currently outstripping green loans and gives his views on his recent experience of using the LMA's Green Loan Principles in transactions.
- **Robin Grenfell** of the Green Investment Group who works in assessing and measuring the impact of green projects and explains what is meant by "Green Frameworks" and the need for defined criteria surrounding environmentally sustainable activities.

I hope you 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.

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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 build on the Green Bond Principles ("GBP") administered by the International Capital Market Association with a view to promoting consistency across financial markets. The GBP are internationally recognised voluntary guidelines that promote 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).

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Green bonds

Q As someone who specialises in capital markets, can you say something about the historical relationship between the green bond and green loan market?

The green bond market has acted as a trailblazer for green financing generally from its beginnings in 2007. It was a bottom-up movement driven by investors wishing to invest in a fixed income product with a sustainable footprint, and had the huge advantage of simplicity: green bonds are easy to understand and structurally no different from a regular bond and with the same credit rating, so they can fit into the existing portfolios of classic bond investors, while at the same time having the bonus for the issuer of attracting new specialised sustainable investors and thus widening the company's investor pool. Moreover, they can be issued using the issuer's standard bond issuance programme documentation.

More recently, with the emergence of sustainability-linked financing, we've seen a bit of a role reversal, so that in many ways the sustainability-linked loan market is at a more advanced stage than sustainability linked bond market: the LMA sustainability-linked guidelines anticipated the ICMA guidelines by more than a year, and sustainability-linked loans were starting to be seen in advance of the benchmark ENEL bond at the end of last year. This has, I think, a lot to do with the nature of the bond market versus the loan market and their respective tolerances for complication and innovation – these sustainability-linked products are by nature structurally more complicated because of the interest variation element, and they continue to evolve by the day as the markets and industry bodies grapple with questions around KPI measurement, more sophisticated two-way pricing structures, prescriptive payment provisions and the like.

Q You have been working with issuers in the green bond market since its beginnings. What have you observed about the behaviour of the markets more recently? What has been the effect of the COVID 19 crisis in particular?

Since really taking off in the mid 2010s, the green bond market had been experiencing phenomenal growth: over 50 percent year-on-year between 2018 and 2019, for example. This was accompanied by a rapid diversification in terms of issuer (particularly into sovereigns) and geography, with 2019 seeing the first issuances out of the CIS, for example.

As a medium to long-term trend, this can be expected to continue. The current market is estimated to constitute only a very small percentage of the total bond market, so there is still a lot of room left for growth.

With the arrival of the COVID-19 crisis, as with the loan markets, green bond new issuance has suffered, with green projects being put on hold, and total issuance volume in 2020 to date dropping significantly.

In their place has come a wave of social and sustainable COVID-related bonds, and we've seen a number of bumper issuances in the first half of the year, notably by the multilateral development banks.

The huge increase in social bonds has meant that the market for green, social and sustainability bonds as a whole has in fact only suffered a relatively small period-on-period drop compared to 2019, notwithstanding the crisis.

Performance of these products in the secondary markets has also been encouraging, with green and sustainable bonds holding up as well if not better than their non-green equivalents: this may be in large part due to the nature of their issuers, generally well rated, resilient and forward-looking companies.

Q What, in your view, are the remaining obstacles that need to be tackled to open up this market even further?

The green and sustainable bond market remains one with relatively high barriers to entry for issuers. A benchmark bond will need to reach a critical size, and there are relatively few potential issuers with green or social projects large enough. There has consequently been a lot of focus among industry bodies like ICMA on how to widen the issuer pool.

Developments in the green private placement market and loan markets will no doubt help in this respect, so that borrowings of €100 million or less will be now be feasible, though there still of course remains the potentially high cost of putting in place the framework and ongoing monitoring and reporting.

For social bonds, there are also attempts to widen their scope to encourage issuance by corporates, who have up until now been absent from the market.

The arrival of sustainability-linked products and "transition bonds" should provide a huge boost by significantly englarging the potential issuer base to include a whole new universe of "brown" issuers in diverse sectors who wish to improve their green performance.

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Guest article: Commercial Real Estate Finance Council ('CREFC') Europe

Q What are the factors that you think have contributed specifically to the growth of green and sustainability linked finance amongst your members?

A number of things converged over the last year or two to make sustainability genuinely mainstream. The public prominence given to climate change by Greta Thunberg and actual climate-related emergencies around the world undoubtedly played a role. When each year seems to bring worse flooding than the year before, no sensible commercial real estate (CRE) lender can ignore climate risk.

It is also increasingly clear that more and more people care both about the sustainability characteristics of their workplace and employer, and about the effects on the planet and society of the way their savings are invested. Both prospective employees and potential investors are likely now to ask firms about their ESG policies and credentials.

Last but not least, the introduction of sustainability-related regulations, notably minimum energy efficiency standards (MEES), made climate transition risk due diligence an essential element of underwriting a CRE loan.

Q How important is the role lenders play in helping to drive the green (and ESG) initiatives?

A few years ago, it was common for lenders to argue that it was hard enough to win a lending mandate without trying to tell property owners how to manage their buildings. The 2017 GRESB debt survey didn't take off partly because it was difficult to define how sustainability benchmarks should work for CRE lending.

Today, we see banks like Lloyds following the likes of ING in the Netherlands and developing green retrofit tools for their CRE borrowers. This is exciting, because retrofitting existing commercial buildings is a key climate challenge: most of the commercial buildings around us will still be here in 2050. Lenders are uniquely placed to play a pivotal role in collecting data about what green retrofit works in what contexts, both operationally and financially, sharing that information across the fragmented and disparate world of commercial landlords, and financing the work. Short of the government taking control, I can't think of a more effective way of greening our commercial buildings.

Q There has been increased regulation over the last few years aimed at promoting sustainability (e.g. implementation of MEES and current plans to tighten those regulations). Do you feel the current suite of regulations is sufficient, or is further regulation needed in order to encourage the Commercial Real Estate industry to focus on green issues and drive sustainability?

I think regulation is essential, because it raises the bar for everyone and frees the market to innovate and reduce the cost of improved outcomes. The influence of regulation is likely to be especially important in the difficult years of COVID and post-COVID recovery. But I see two particular challenges at present.

The first is that MEES are based on Energy Performance Certificate (EPC) grades, and the Better Buildings Partnership[2] has shown that EPCs are a more or less useless guide to how buildings actually perform. To achieve climate-related goals, regulation needs to focus on how design affects the operational performance of buildings (following the example of NABERS in Australia).

Secondly, there are just too many standards, definitions, initiatives, templates and frameworks, developed by industry and campaigning groups and national and international policymakers. It's especially hard with weak strategic policymaking and struggling multilateral institutions, but we need regulatory clarity and consistency if we are to tackle climate change effectively.

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[1] 2017 GRESB Debt Results
[2] Better Buildings Partnership: Energy Performance Certificates for Buildings - Call for Evidence

Guest article: HSBC UK Bank Plc

Q It's important to remember there is a distinction between "Green Loans" and "Sustainability Linked Loans" ("Green Loans" being loans for green projects, e.g. new green infrastructure", where as "Sustainability Linked Loans" being available to Borrowers achieving defined environmental, social and governance targets). The current position is that the growth of sustainability-linked loans is significantly outstripping the growth of "Green Loans". Why do you think this might be the case and is it a trend you predict is set to continue?

In answering this question it is worth comparing the two loans in greater detail. The key difference is that Sustainability-Linked Loans ('SLL') look at a company's overall sustainability strategy, whereas Green Loans require the loan to be used for a project with clear environmental benefits.

As mentioned in the question, the use of proceeds is not the determinant in the categorisation of a SLL. The goal of a SLL is to improve a borrower's sustainability profile and the borrower's cost of capital is linked to a pre-defined set of sustainability performance targets. It is effectively linked to how a company is changing the way it is working as it becomes more sustainable, and this provides borrowers with greater flexibility as the purpose of the loan can be much broader and funds can be used for general purposes.

A Green Loan, however, is aligned to a green project or an asset which has clear environmental benefit.

As the Green Loan market continues to evolve, particularly with regards to retrofitting (see comments below) then I expect to see an increase in the volume of green loans. Ultimately, over two-thirds of the commercial buildings in existence today will be in use in 2050 and therefore to reduce a buildings carbon footprint and improve energy efficiency, significant investment in Green projects to retrofit buildings will be required. The key determinant in achieving this will be to have a standard for retrofitting and agreeing a benchmark measure which would allow the project to qualify as a Green activity.

Q How was your experience of using the LMA's Green Loan Principles and what are your views on their application in your particular area, which is Real Estate Finance transactions. I know you have concerns that whilst they may apply well to new-build developments, their application to retro-fitting exiting buildings is less straightforward.

HSBC worked with the LMA globally who published their Green Loan Principles on 21 March 2018, with a new guidance document launched on 5 May 2020. HSBC UK was the first bank to have a specific offering aligned to the Green Loan Principles and we became the first bank to offer a Green RCF; we continue to innovate in this space.

To date we have found the LMA's Green Loan Principles relatively easy to work with for Real Estate Finance transactions. The principles provide a clear guidance on a set of standards that must be achieved for the loan to qualify.

By working closely with a client we have been able to establish the key elements of the projects which have ensured that the use of proceeds and sustainability objectives can be readily identified. For tracking of proceeds we ensure that certification is provided by either an external third party (such as a Project Monitor for the development facilities) or the borrower certifies that the proceeds have been used in accordance with their Green Finance Framework, verified by an external third-party. Final sign-off from a reporting perspective is achieved by the accreditation of the project, such as a BREEAM or LEED assessment and certification, or an equivalent recognised standard.

This process works particularly well for new commercial buildings as the planning consent is often conditional on achieving a minimum accreditation standard. However, for retrofitting, this standard is less well defined, but I expect this market to develop in the near term.

Q How do you think the "greenness" of a transaction will impact on the economics. E.g. we've heard talk of a "green premium" and a "brown penalty" in the real estate market. Are you seeing a green premium reflected in the economics of your real estate finance transactions yet/is this something you expect more of in the future?

There has been a lot of discussion on this topic. The general view is that there is insufficient data to clearly evidence how green assets behave during financial crisis. This is despite growing evidence that funds geared towards sustainability can actually perform better, which has been further evidenced during COVID-19. HSBC research has found that 'climate-focused' stocks outperformed others by 7.6% from December and by 3% since February, while stocks with ESG scores beat others by c.7% on average.

However, in today's market, logic dictates that a green premium is justifiable as tenants are benefitting from investment to deliver buildings to the highest environmental and sustainability standards, so developers/landlords are able to demand a premium.

Going forwards, as Green buildings become more prevalent and 'the norm' then we could be more likely to see a brown penalty and this will ultimately reflect the requirement for additional investment to ensure that buildings meet the requisite standards.

The underlying economics are being driven by the basic fundamental of supply and demand. We are continuing to see greater demand and focus on sustainability and the workplace environment from tenants, investors and work force itself. This may well become even more acute as a result of the COVID-19 pandemic.

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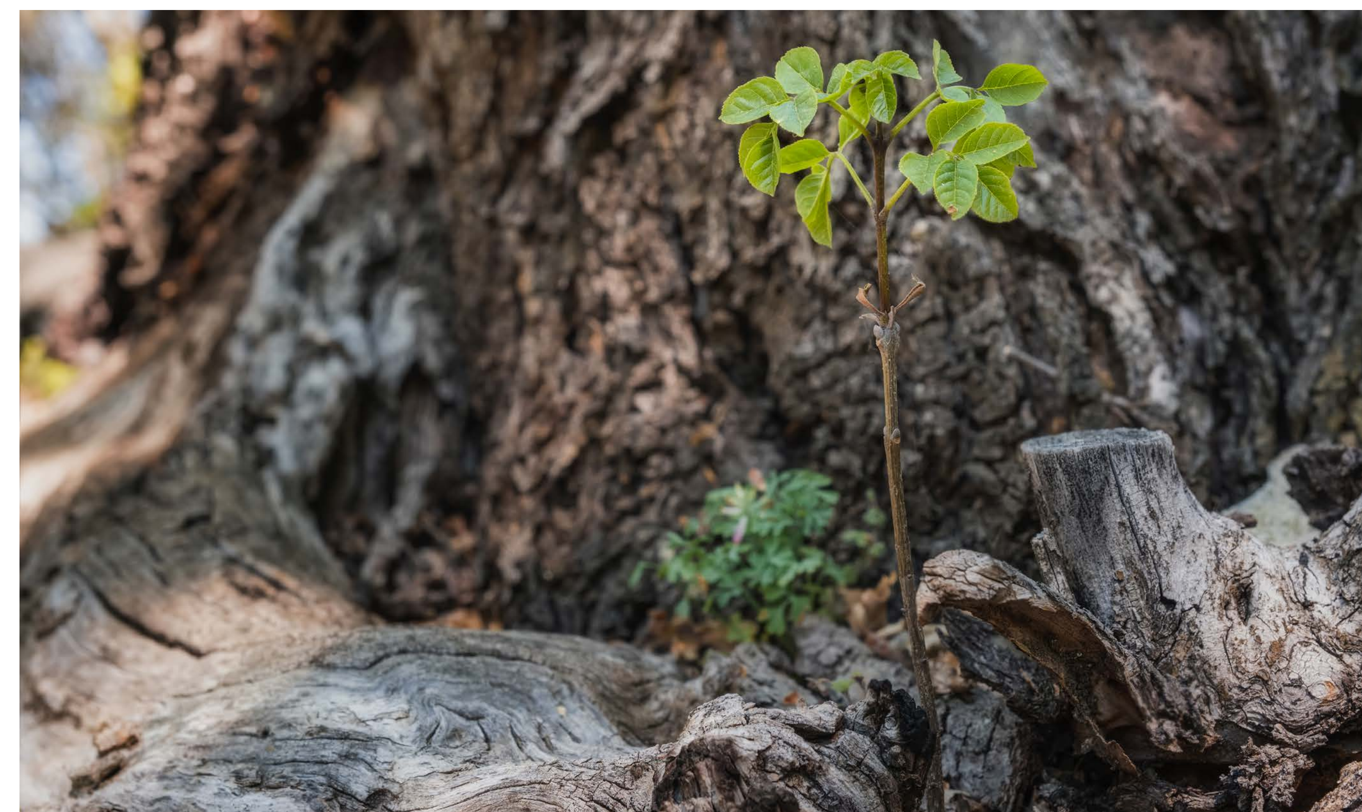

Guest article: Green Investment Group

Q Given the obvious importance the Government are placing on the financial sector helping to drive green initiatives, a prime consideration is how effective the investment is and whether it meets targets dictated by the finance documents. In this context, what are "Green Frameworks" and how important a role do they play in this process?

The effective and lasting impact of green initiatives is more important now than ever. The whole world is watching the investment community to see if the aspiration to meet the Paris Agreement and to "build back better", from the economic fallout of the COVID-19 crisis, becomes a necessary reality.

Momentum behind green investment has been building for over a decade but the urgency required to deal with climate change and to aid economic recovery from the COVID-19 crisis makes it more important than ever. As the market grows and as more capital gets deployed to green projects it is crucial that informed decisions are made and that the public and those vested in the success of these initiatives trust those decisions.

This is where evidence-based Green Frameworks play an essential role.

Green Frameworks define a process for ensuring that investment is deployed into defined green or sustainable activities.

There are high-level guiding Green Frameworks available, such as the "framework for sustainable finance standard ISO3221" currently under development by the International Organization for Standardization, providing guidance on how institutions can be structured to embed sustainability, and the "EU Taxonomy Regulation", providing a classification system for environmentally sustainable activities. There are Green Frameworks offering guidance on how to structure green debt instruments (e.g. LMA "Green Loan Principles" or ICMA "Green Bond Principles"). Following such guiding Green Frameworks provides confidence to stakeholders.

Green Frameworks can also be developed by organisations to embed green principles into investment decision making and broader business operations, referred to as green evaluation frameworks. Through their development, the organisation embeds industry standards and organisation-specific green criteria into decision making. The process of developing a green evaluation framework and the benefit that comes from its implementation is a significant opportunity for financial organisations, as we found at the inception of the UK Green Investment Bank. It provides an opportunity to cascade an organisation's green vision through the entire investment process and a means of consistently reporting its impact, which we have now applied to over £20 billion of green investment.

The Green Investment Group began life as the UK GIB and was created by the UK Government in 2012. At this time there wasn't a methodology with sufficient academic and scientific rigour that could be applied pragmatically, day-in and day-out, through a commercial investment process. At the UK GIB, we had to develop our own and it started with making green impact the beating heart of the business's mission. It is testament to the value of the framework that it has remained a fundamental part of the Green Investment Group since its acquisition by Macquarie Group Limited in 2017.

Investors do need to prepare themselves for managing and reporting alignment to Green Frameworks. This includes ensuring adequate capacity in the organisation to effectively implement and maintain the framework so they can ensure that their strategic approach and processes are designed to maximise transition opportunities and minimise risks.

Q On 18 June 2020 the European Parliament adopted the EU Taxonomy Regulation which lays down six environmental objectives and allows economic activity to be labelled as "environmentally sustainable" if it substantially contributes to climate change mitigation or adaptation objectives without significantly harming any of the others. How important is it to have some defined and agreed criteria around whether activities are environmentally and socially sustainable?

Just as sustainability can mean all things to all people, green labelling can be fraught with misinterpretation. When the UK GIB was established, it was a fundamental first step to define green impact in a way that was clearly understood and practical to implement, through a commercial investment process. This gave confidence to the investment community as well public stakeholders. We continue to publish our green investment criteria along with a guide to our green investment handbook to give the market confidence in our framework and so that our stakeholders can see the value add of a Green Investment Group project.

The EU Taxonomy provides a level of confidence at a strategic level by setting out economic activities that can make a substantial contribution to climate change mitigation or adaptation. It also excludes those activities that would undermine climate change mitigation efforts and it is in the exclusion of activities that a taxonomy approach is most powerful, reducing the risk of unsustainable activities being labelled as "sustainable".

However, even if an investment is into a project that is included in the EU Taxonomy there is still a need to assess negative impacts, which the taxonomy addresses through the principle of Do No Significant Harm. When it comes to making investment decisions it is important to look at the forecast contribution to each criteria separately, so that both the positive and negative impacts can be identified and assessed.

Further to defining what is meant by green or sustainable, agreeing the criteria with stakeholders is also vital to creating a framework that is applicable and relevant. Those stakeholders include parties reliant on your performance, such as investors and partners. In many cases an organisation will need to seek advice from proven experts who can align the functional structure and implementation of a measurement and monitoring framework, with the organisation's stated sustainability objectives and commitments.

Transparent communication of measured impact and demonstrable alignment to defined Green Frameworks is now an expected part of green investment. More organisations are embracing the value of impact reporting as an effective means to show the positive environmental benefits of their activities. Impact reporting requires consistency across the market to be meaningful and comparable. Efforts such as those by the International Finance Institutions to harmonize greenhouse gas accounting have been successful in bringing about consistency in one such area. These efforts need to continue as investors look for the increasing green return on their investments. This is not just for impact investors but those seeking proxies for compatibility with a future economy.

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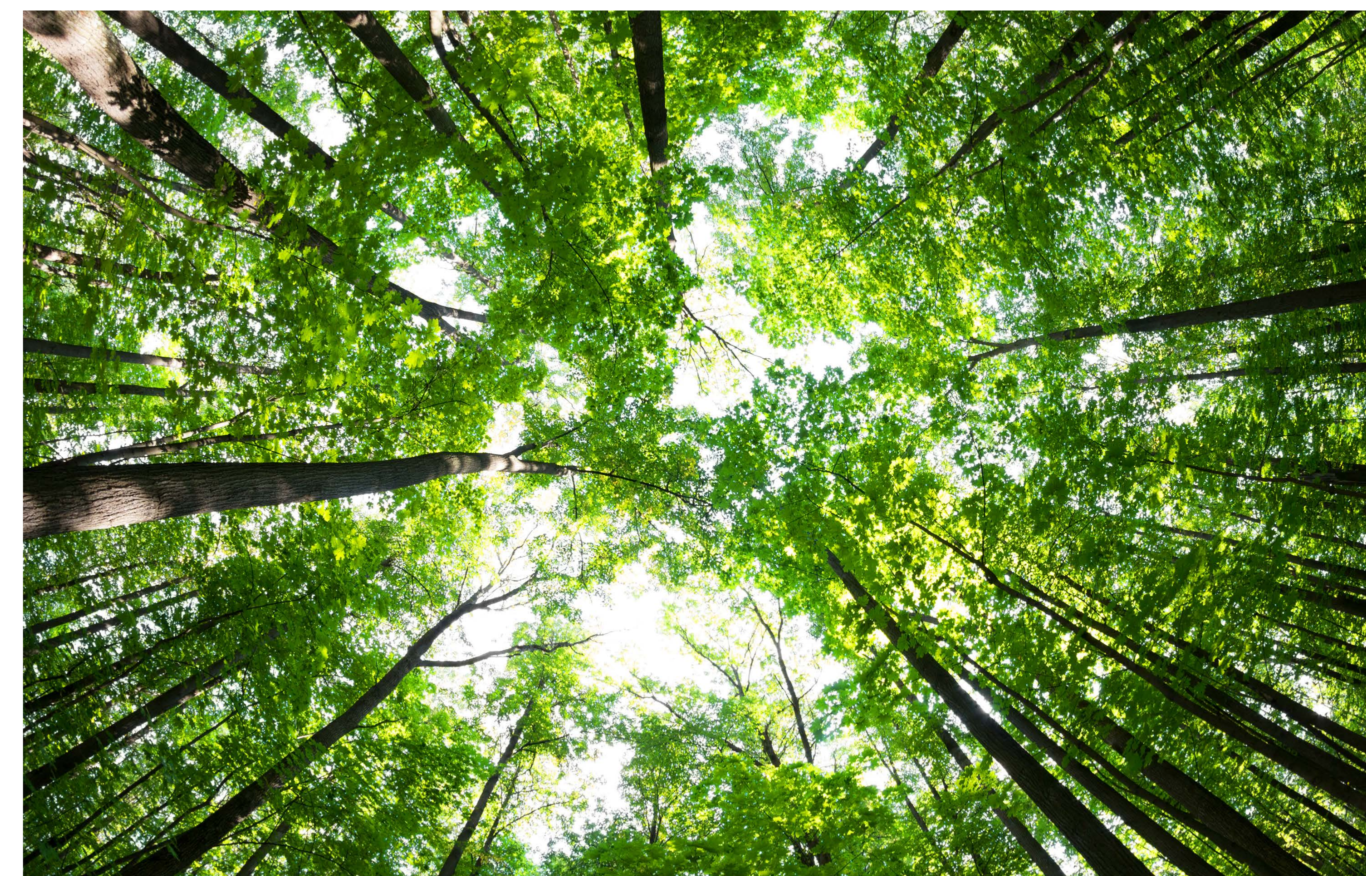

Real estate finance

Q How prevalent is green/sustainability-led financing in REF?

Whilst both green and sustainability-led loans are becoming increasingly common in the sector, the growth of sustainability-led loans has been particularly apparent. The concept of a sustainability-linked loan is broad and so presents opportunities for borrowers who do not invest in green projects but nonetheless do have a good (or improving) sustainability profile.

In terms of green loans, the funding of the construction of "Green Buildings" has appeal to lenders. These buildings have the potential to achieve higher rents, higher occupancy rates and higher valuations than their non-green competitors, thereby improving the value of the lender's security.

Q Can you give some examples of how green/sustainability-led financing has been used in your sector?

In 2018, Wells Fargo provided US$23 billion of sustainable financing, 63% of which went towards low-carbon solutions such as green buildings, renewable energy and clean technologies, with the remainder supporting businesses and projects focused on environmental activities[3]. In 2019, ING also reflected its commitment to sustainable finance in its support of 60 green and sustainability improvement loans[4]. More recently, HSBC UK, Barclays and NatWest issued a £450 million five-year facility to Derwent London featuring a £300 million "green tranche", making it the first revolving credit facility provided to a UK REIT that meets the LMA's Green Loan Principles[5]. Derwent intends to use the proceeds to fund development and refurbishment projects, such as 80 Charlotte Street W1 and Soho Place W1, which receive third-party verified Green Building certification.

Like Derwent, many companies operating in the real estate sector have mapped out long term sustainability strategies such as the listed property investment and development company, Helical. Helical identifies key priorities which it aims to integrate across its business, such as reducing its carbon output by 2025 and bringing social, economic and environmental benefits to the areas in which it operates.

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

The trajectory of the Minimum energy Efficiency Standard Regulations ("MEES") means a large number of Landlords will be considering retro-fitting works over the next decade. Whilst it is currently unlawful for a Landlord to let a commercial property with an Energy Performance Certificate ("EPC") rating below E, from 1 April 2023 all existing lettings of commercial property must also meet this benchmark. Going further, the Government's target is that from 2030 all rented non-domestic property should have an EPC rating of at least B (provided the action required is deemed cost effective by meeting a seven-year payback test). This drive for energy-efficient buildings (backed by legislation) will also mean that the majority of new build developments will seek to be zero carbon.

The significant costs this will entail for a large number of property owning companies, will lead to a sharp increase in the demand for financing for these works.

Q What do you see as the important next steps for green/sustainability-led financing to become more common?

Avoiding "green washing" is imperative in order for green/sustainability led finance to gain further traction and remain credible. The LMA's Green Loan Principles (2018) and Sustainability Loan Principles (2019) provide guidance on the criteria that should be necessary in order to be classed as a green or sustainable loan. The EU Taxonomy Regulations also assist in this regard by creating a classification of environmentally sustainable activities. Ensuring these principles and regulations are adopted and enforced will help provide clarity as to what borrowers must do in order to qualify for a green/sustainable loan.

This increased certainty regarding the borrower's green/sustainable obligations and reporting requirements will give lenders the confidence to offer improved loan terms (principally margin reductions) to borrowers who meet the required criteria and obligations.

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Rail

Q How prevalent is green/sustainability-led financing in Rail finance?

Based on CO_2 emissions rates, rail is one of the greenest modes of transportation available. This is likely to increase with investment in battery and hydrogen powered trains. Hitachi recently signed an agreement in relation to the development of a battery pack suitable for powering zero emission trains. ROSCOs like Porterbrook are developing flexible green products. More retrofitting of green and sustainable technology onto existing fleets is expected. Investment in the sector will therefore play a significant role in leading the way towards the EU and UK's long-term strategy of achieving net-zero greenhouse gas emissions by 2050.

Against this backdrop, a number of institutional investors, many industry stakeholders across Europe, rolling stock owners and infrastructure managers alike, have raised finance through access to green bonds and sustainability-led financing.

Q Can you give some examples of how green/sustainability-led financing has been used in your sector?

In the UK market, both Eversholt and Porterbrook have issued green bonds. Porterbrook refinanced existing bonds, at the end of last year, against a green framework in order to achieve better returns. The continued focus for owners will no doubt be to invest in new technologies (to upgrade existing fleets) and investment in new, more efficient, fleets.

Train operators have also raised funds on a "green" basis to achieve better terms. In Italy, the open access high speed train operator Italo signed a €1.1 billion syndicated loan in November 2019, dubbed to be the world's largest green loan in the transport sector at the time. There have also been examples of train operators seeking to comply with new climate laws and policies in order to raise their credit rating scores. Doing so has helped operators improve their chance of securing cheaper finance.

Electrification of railway lines has been on Network Rail's agenda for some time. Given the big upfront costs associated with electrification, coupled with the fact that electric trains and tracks are faster and greener, this area is a prime candidate for future green investment. National Grid have already raised green finance this year, the proceeds of which they intend to use towards financing clean transport infrastructure, such as electrification of railways.

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

In May 2019, the European Commission commissioned a study entitled "Development of a methodology to assess the 'green' impacts of investment in the rail sector." The purpose of the study was to establish a common set of standards for assessing railway assets and activities as environmentally sustainable, particularly in the context of sustainable finance.

In the UK, the Rail Safety and Standards Board (RSSB) together with the Rail Industry Decarbonisation Taskforce, produced a report in July 2019 for the Minister for Rail. The report sets out strategic recommendations for the industry to achieve carbon neutrality. Included in these recommendations is the principle that the industry contribute to the net zero carbon target in a "cost-effective manner". The report suggests that the UK Government should set out clear, consistent and enabling policies to facilitate this. This will no doubt be key for green and sustainability-led finance in the industry going forward.

More recently (July 2020), the Campaign for Better Transport has issued a publication looking at recovery in the rail industry post-COVID 19, advocating that the transport system (including rail) should be transformed as part of a green recovery programme, improving our environment and our health, creating jobs, tackling social exclusion and helping the economy to recover. Green rail finance will have a key role to play on this whether from a rolling stock, an infrastructure perspective or otherwise.

Q What do you see as the important next steps for green/sustainability-led financing to become more common?

The RSSB report on decarbonisation, referenced above, called for the results of the Williams Review to lead to a structure for the UK rail industry that effectively enables, incentivises, monitors and regulates the route to net zero carbon. It will be important to see what this means in practice and how it will act to incentivise increased green and sustainability led financing in the rail sector going forward.

In order to continue to be at the forefront emissions targets and reap the benefits of priority access to green financing, the rail industry will need to demonstrate continued efforts towards further efficiency of rolling stock. Further electrification of rail infrastructure, to allow for more efficient rolling stock on our networks, will also be a key contributing factor towards this.

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Aviation

Q How prevalent is green/sustainability-led financing in aviation finance?

The adoption of green and sustainability-led financing initiatives has been relatively slow in the aviation sector. Why?

Alternative financing options – pre-COVID, the airline industry was enjoying an Indian summer of significant and sustained growth, bringing with it a swathe of capital offered at extremely tight pricing and putting potentially more expensive and restrictive green financing products at a competitive disadvantage.

Fuel optimisation – improving fuel efficiency has been one of the guiding principles driving aircraft innovation for decades. This has, to some degree and for some time, insulated the industry from the full glare of environmental reform.

Barriers to entry – commercial aircraft and engines are technologically complex and expensive assets, the production of which is dominated by a small number of well-resourced manufacturers. The opportunities for new disruptive green technologies have been limited.

Absence of uniform KPIs – the determination of a clear set of industry key performance indicators – whether relating to CO_2 or N2O emissions, noise pollution or other metrics – to standardise performance against ESG targets has been slow to develop, making the business case for green financing difficult to establish.

Legal difficulties – finding a consensus on the methodology for, and implementation of, a global scheme to neutralise growing aircraft emissions has been a significant challenge. The introduction of CORSIA, a global carbon offsetting scheme, by IATA in 2019 is encouraging but is yet to be tested.

Despite these challenges, the landscape has begun to change notably in the sector over the past two years. A shift in consumer attitudes and governmental focus has led to several larger airlines taking positive steps to both commit to a reduction in their CO_2 emissions and to improve their environmental sustainability – in some cases with green financing support.

Q Can you give some examples of how green/sustainability-led financing has been used in your sector?

Green financing products, which essentially operate to ensure a "green" use of proceeds, have understandably been targeted at transactions which can deliver tangible ESG gains. Though the number of deals has been limited, we have seen some encouraging "firsts" involving the selection of more fuel-efficient aircraft types and the development by airlines of environmentally friendly real estate projects for crew accommodation and training purposes.

Sustainability-led products, which instead look more generally to the borrower's performance against a set of sustainability performance targets (SPTs), offer potentially wider application for companies looking to improve their overall ESG performance. Both Sydney Airport and JetBlue are reported to have recently drawn on large general corporate debt facilities with flexible margins linked to the borrower's performance against specified SPTs.

Though adoption has to date been slow, the potential for sustainability-led financing products in the aviation sector is significant as airlines look to deliver against their carbon-offset obligations under CORSIA (and in some cases, to meet their own more onerous ESG corporate policy goals).

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

The CORSIA carbon offsetting scheme – which is intended to apply in due course to all airlines operating on international routes and seeks to stabilise CO_2 emissions from international aviation from 2021 – is likely to act, with investor support, as an important catalyst for the implementation of projects qualifying for green and sustainability-led financing products.

Tellingly, there has been visible "buy-in" in the aircraft financier and lessor community in favour of an ESG improvement strategy. The Aviation Working Group (AWG), a leading industry not-for-profit, has begun work on an initiative to standardise ESG metrics for the purposes of aircraft finance and leasing. Some aircraft lessors have also been reported to be considering offering more attractive lease rates to airlines with better ESG rates.

It has also been reported in the press that several government COVID support packages for airlines have been issued with green conditions attached. European air transport and aerospace trade associations have similarly called on EU governments to finance a green recovery from COVID through public funding for carbon reduction projects.

Q What do you see as the important next steps for green/sustainability-led financing to become more common?

Cultural change, government led-policy and stakeholder pressure will each continue to have an important role to play in the wider adoption of green and sustainability-led financing in the aviation sector. The key driver will however be investor appetite in the market to support these products – including in the short to medium term, ECA-supported investment. To achieve this – and help ensure longer term viability – ESG targets need to be measured and applied consistently across the sector. As the AWG initiative shows, the market has already begun to move in the right direction on this. The unprecedented impact of COVID on traditional liquidity in the industry presents a compelling opportunity to accelerate the process.

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Shipping

Q How prevalent is green/sustainability-led financing in ship finance?

At the time of writing, this is a 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.

Q Can you give some examples of how green/sustainability-led financing has been used in your sector?

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.

Q 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/operators in the last years. A key example is 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.

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.

Q What do you see as the 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.

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Leasing

Q How prevalent is green/sustainability-led financing in the leasing market?

Both green financing and the lifecycle of assets have been topics of conversations in the leasing market for more than ten years and we have a number of influential players in the market who promote this way of financing and ensure that assets have a second life once they come off lease and are therefore sustainable. For those of you who are not familiar with this market, lease finance is where the financier (known as the "lessor") owns an asset and grants the borrower (the "lessee") the right to use the asset for a period of time in consideration for the payment of rent.

You can appreciate that in "green" projects there are often substantial amounts of plant and machinery that lend themselves itself to being financed through a lease structure for example in an anaerobic digestion facility. Over the years the leasing industry has worked on a large number of lease structures which involve green projects; some of them on a project finance basis and others on a credit basis. Some of those green projects have been technically advanced at the time of funding. One example is the use of leasing to fund combined heat and power plants used in greenhouses growing tomatoes – the carbon emissions from the CHP plant is used in the greenhouses to raise CO_2 levels and accelerate the growth of tomato plants in the greenhouses.

A number of financiers take residual risk in the assets that they lease to customers and on return from the customer they are committed to effective lifecycle management of the assets, extending the life of the equipment they lease. This is particularly prevalent in the IT sector. One example of this is **3 Step IT** who have built circular economy principles into their approach to IT lifecycle management. They regard it as a better value approach that reduces the environmental impact of IT. Its solutions make it easy for the lessees to return the leased devices to 3 Step IT, who then securely erases the data and refurbishes them for secondary use. The company says that 97% of retuned equipment finds a new home and the remaining 3%, usually faulty or broken equipment, is responsibly recycled through its recycling partners.

Sustainability-led financing is not as far advanced as green financing in the leasing industry but it is on everyone's agendas and is an area of growth. As many of the lessors in the market are banks, the initiatives the banks are generally taking are filtering through to the leasing companies.

Q Can you give some examples of how green/ sustainability-led financing has been used in your sector?

One of the biggest sectors in the leasing market is automobiles including cars, vans, lorries and buses. Up until recently many of these buses, vans and lorries have been powered by diesel but as there has been a great deal of investment in developing battery or hydrogen powered vehicles, the market has been turning their minds to electric vehicles for the last few years. Local authorities are imposing more charges in inner cities for diesel vehicles and there are more grants available for those people who use battery or hydrogen powered vehicles resulting in a powerful incentive for operators of these vehicles to go green. Buses are a good example of this. Most buses are leased (either by way of an operating lease, a finance lease or hire purchase contract). Generally speaking, battery powered buses are currently twice the price of diesel buses – the additional cost being the battery. Lessors are looking at the battery powered buses and considering what risk they are prepared to take in the residual value of these buses. The technology is still relatively new. One of the issues that the lessors have to tackle is the fact that the battery on a bus will not last for the life of the chassis and so will need to be replaced at a high cost and will need to be disposed of. A new entrant, **Zenobe Energy**, has been working on a solution to this problem and, by way of example, in June of this year assisted Abellio in launching its first fleet of electric buses in London[6]. Zenobe has provided Abellio with an end to end solution including financing of buses, the provision of batteries and the charging system at the depot for 34 electric buses.

Since 2014, **Future Energy Solutions** has been replacing old lighting in car parks and warehouses with LED movement controlled lighting, saving their customers thousands of pounds in energy costs.

The leasing industry has also been very active in the renewable sector with projects in solar panels, anaerobic digestion plants and recycling plants and machinery. Some of these can be highly structured depending on the credit of the borrower. We have acted on a number of project financing involving leases of the core plant and machinery involved in green projects.

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

The Finance & Leasing Association (the "FLA") is the UK's leading trade body for firms providing asset finance and it has lead a number of initiatives with lenders and industry suppliers to develop thinking on how to use green and sustainability-led finance in the leasing industry. Last year, for example, it bought together various interested parties including the Low Carbon Vehicle Partnership at the Labour and Conservative Party Conferences, to get expert opinion on measures the Government could take to help increase the uptake of low emission vehicles and the role of motor finance to support that. This mainly focused on the consumer end of the market and the issue of ensuring that there are sufficient charging points located round the UK to give consumers the confidence to purchase low emission vehicles.

Q What do you see as the important next steps for green/sustainability-led financing to become more common?

Government-led policy will be the quickest way to develop the use of green equipment and require companies to consider the life cycle of assets thereby increasing the need for lenders to do the same. With increasing environmental regulations and reporting requirements, businesses will have to focus on sustainable operations and the leasing industry can assist with that goal. We need to move away from the traditional linear take-make -dispose approach to the circular take-make-reuse model.

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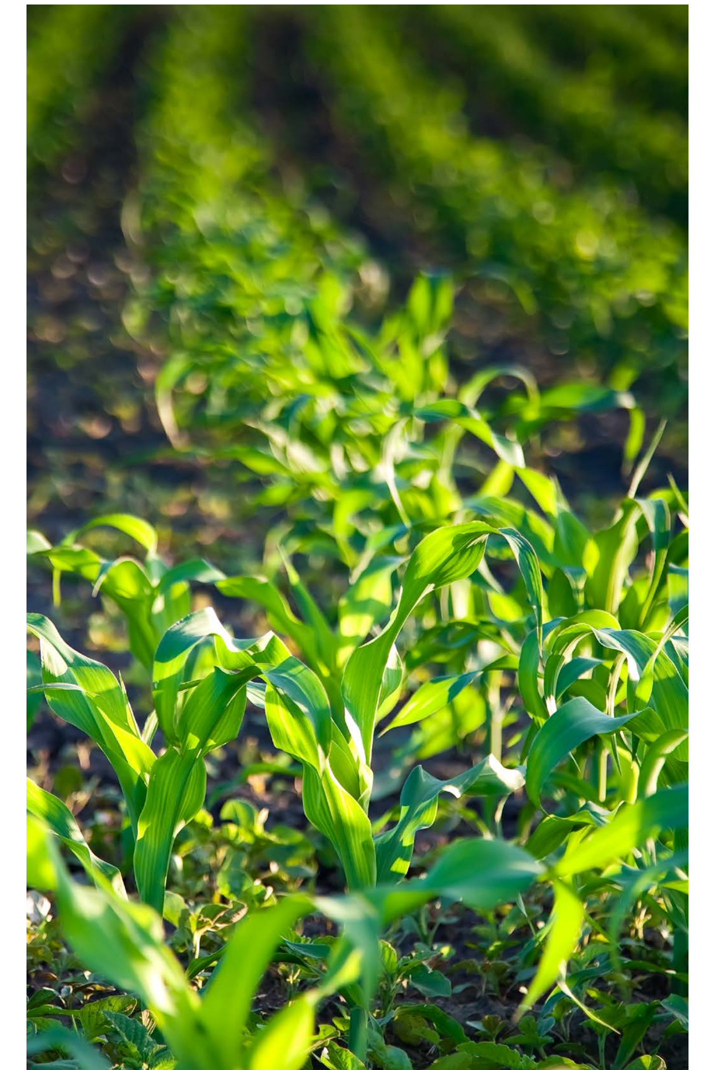

[6] https://www.shlegal.com/news/stephenson-harwood-advises-zenob%C4%93-energy-on-20-million-financing

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