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ESG Market Update

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Sustainability is becoming a fast fixture in real estate, which is reflected in the growing variety of sustainability-linked loan products available to the market. The exceptional growth of the sustainable loan market paired with the extensive appetite for sustainability linked loans, has sparked many debates in the industry over the need for transparency, particularly in relation to KPIs. This was a core theme of the LMA's recent panel discussion "*Sustainable finance: The difficult questions ahead*" and the LMA expanded on it further in their recently released "*Guide to the application of the Sustainability-Linked Loan Principles in real estate finance and real estate development finance*". This guide has helped to provide further clarity on the challenges the market currently faces.

The LMA's recent event, "*Sustainable finance: the difficult questions ahead*" (the **"Sustainable Panel"**) opened with a clarification on the difference between green loans and sustainability linked loans (**"SLLs"**), which was also covered in their recent guide. On the one hand, green loans can only be used to finance green projects and are slightly lagging behind their broader counterparts in terms of popularity. In contrast, SLLs are growing extensively, with Europe dominating the market. The key feature of SLLs is that they incentivise "improvements to the borrower's sustainability performance by aligning the loan terms with pre-defined sustainability performance targets." This means that borrowers of any industry can be incentivised to take sustainable steps. This will enable us to achieve the pace of change we need in order to meet environmental targets set by the "*UN Sustainable Development Goals"* and "*Race to Zero Targets*".

In order to be successful and maintain integrity, SLLs need to ensure that the KPIs which underline the SLLs are, as stated by the Sustainable Panel, "material, relevant and core to the company" but ambitious enough to be fit for purpose. As the LMA pointed out in their recent guidance, this is particularly challenging in the REF market as lending is often asset-based and borrowers are commonly SPVs. Therefore, assets and borrowers have no historical data to draw upon, which raises the question of how targets and benchmarks should be set.

The key it seems is data transparency and monitoring. As discussed by the Sustainable Panel, data can be either peer or science based, helping to calibrate the right level of ambition without relying too heavily on the borrower's own historical data. Borrowers could also draw on the sustainable strategy of their parent group or rely on independent third-party assessors to provide reports on assets. In order to choose the most appropriate dataset for comparison, the LMA guidance suggests that borrowers should provide lenders with information on their sustainability strategy and relevant KPIs, ideally before the start of a transaction, and at latest, at the term sheet stage.

However, the Sustainable Panel stressed that we should not halt progress in the hope that a perfect data set may arise in the future!

The Sustainable Panel also highlighted the role of monitoring, commenting that an increase in the number of sustainability-monitoring roles in the industry will also help by improving transparency and (as mentioned in our previous article "The rise and rise of ESG") as a way of ensuring a collaborative response between lenders and borrowers. Examples of such roles include sustainability officers on the company side, ESG officers on the banking side and ESG rating providers as independent third parties.

Following on from this, the Sustainable Panel discussed how KPIs are evolving in SLL. Of note there has been a rise in KPIs associated with the ‘S’ in ESG, but it was noted that it is particularly difficult to measure the social impact of a borrower as it often stretches ‘beyond the walls of the company’. For now, the industry seems to be centred on what they know in the 'S' space, focusing on health & safety and diversity based KPIs.

As the industry continues to evolve, borrowers' use of data will become increasingly sophisticated in order to keep up with the demands of lenders. It will certainly be interesting to see how the use of data and potential trends develop in the coming years – watch this space!