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Sustainability-linked loans in Turkey: the current state of play

2021

Introduction

As regulators, shareholders, investors and wider society increasingly focus their attention on Environmental, Social and Governance (ESG) matters, they have crept up the boardroom agenda of large Turkish companies and financial institutions and are now firmly in the spotlight on financing transactions in Turkey. Consistent with trends seen in other markets, ESG factors are fast becoming a common feature of the Turkish loan market, with many Turkish companies and lenders looking to find ways to enhance both their financial and reputational position with investors and customers by capitalising on the current focus on ESG.

We have had the privilege of supporting our clients on several sustainability-linked loans in Turkey and in other markets, including the very first sustainability-linked loan in Turkey and the world's first sustainability-linked loan made available to a bank. This note provides an overview of how the global sustainability-linked loan trends are playing out locally in the Turkish market.

What are sustainability-linked loans?

Sustainability or ESG-linked loans aim to encourage borrowers to improve the sustainability of their businesses through financial reward for achieving agreed sustainability performance targets (**SPTs**), as measured by key performance indicators (**KPIs**), at regular intervals during the life of the loan. This is usually done by including an 'ESG adjustment' on the margin.

Note that 'green loans' are a separate category of product, which drive ESG improvement by requiring the loan proceeds to be applied towards a specific environmental project/impact.

Green loans are inherently constrained by the availability of suitable green projects that can be the subject of the relevant financing.

Unlike green loans, there is no need for a sustainability-linked loan to be part of an underlying environmental financing, so it can be made available to almost any borrower, for almost any purpose. This versatility has been a major contributing factor in the explosive growth of sustainability-linked loans over the last few years.

Benefits of sustainability-linked loans

Sustainability-linked loans are generally regarded as mutually beneficial to borrowers and lenders. In addition to the inherent benefits associated with encouraging more sustainable development, those benefits include:

– enhancing reputation as a good corporate citizen with investors, customers and other stakeholders;

– access for borrowers to pools of capital that are looking to be put to work in the ESG space; and

– promoting sustainable long term growth and profitability.

Regulatory aspects

Turkey has signalled its commitment to sustainable finance through becoming a signatory to the United Nations' Declaration on Sustainable Finance – an initiative which has since also been backed by many of Turkey's leading banks. In addition, the Banking and Regulatory Supervisory Authority (**BRSA**) has recently published the 'Guidelines on Extension of Loan and Monitoring Processes' (the **Guidance**), which requires banks to adopt internal policies and procedures (Guidelines) that will govern the granting and monitoring of sustainability linked financial products (including sustainability linked loans). This is a relatively recent development and practice with respect to the Guidance is still developing.

While not specifically related to sustainability-linked loans, the Capital Markets Board of the Republic of Turkey (**CMB**) amended the 'Corporate Governance Communiqué' last year to ensure that public companies take concrete steps towards sustainability (including financing themselves in a sustainable manner) and published the 'Sustainability Principles Compliance Framework', which sets out sustainability principles for public companies to follow. While it is not mandatory for companies to comply with these principles, they are obliged to report in their annual reports whether or not they have complied and, if they have not done so, their reasons for not doing so. This is commonly referred to as reporting on a 'comply or explain' basis. Although not directly applicable in Turkey, the rapidly evolving sustainable finance regulatory landscape in Europe is expected to be highly influential in Turkey.

How are sustainability-linked loans documented?

Sustainability-linked loans are documented in much the same way as a borrower's other loans. Typically, the documentation will be based on the borrower's existing loan documentation (or, if no such documentation is available, a Loan Market Association (**LMA**) template) with the 'ESG features' being added through the inclusion of certain additional provisions. In most cases these additional provisions can be incorporated relatively easily without substantially amending other parts of the documentation and, as such, the documentation aspect of sustainability-linked loans is generally regarded as relatively straightforward.

Although the LMA has published (and recently updated in May 2021) a useful set of Sustainability Linked Loan Principles (the **LMA's SLLP**), which provide voluntary yet highly influential recommended guidelines, there are currently no market standard terms (or LMA standard wording) for sustainability linked loans.

There are however some common features in the way ESG factors are incorporated into loan documents in the European loan markets and we are also starting to see more specific trends emerge as to how these features are incorporated into loan documentation for Turkish borrowers. We touch on those common features and trends below.

Margin adjustment

The most common way of encouraging a borrower to improve its sustainability or ESG profile is a pricing incentive (usually a margin ratchet) linked to the borrower's performance against the agreed KPIs or SPTs. In more recent deals (including in Turkey), this pricing adjustment tends to be structured on a two-way basis, so that a failure to comply with the relevant targets by the borrower may also result in an increase in the margin. The mechanics for this are similar to a margin ratchet based on financial ratios.

Typically the margin adjustment is relatively small – with adjustments of 5 basis points upwards or downwards being relatively common in corporate loans. For Turkish deals it is not unusual to see even more modest adjustments, with the adjustment occurring either quarterly or semi-annually. In all cases the adjustments are non-cumulative and, where there are multiple SPTs, it is common to include a margin 'grid' which may provide for a downward adjustment if all targets are met, no adjustment if some (but not all) targets are met and an upward adjustment if no targets are met.

Which ESG targets?

Borrowers and their lenders are afforded considerable flexibility in determining the nature of the KPIs and SPTs. The targets can relate to any aspect of ESG matters and are often (but not always) negotiated on behalf of the lenders by a Sustainability Co-ordinator or Sustainability Structuring Agent.

The LMA's SLLP contain a list of common KPIs but they are indicative only and are capable of being adapted to suit a particular borrower and the sector in which it operates, so there is scope for the parties involved to think creatively in identifying suitable targets. The key overriding requirement is that those targets are robust, meaningful and ambitious having regard to the borrower's business and its recent performance. In some cases, borrowers may be encouraged to seek, as a condition precedent to utilisation of the loan, a third party opinion as to the appropriateness of the proposed KPIs and SPTs, although this is not mandatory and is less common in Turkey.

Traditional environmental targets are common (examples being the reduction of greenhouse gas emissions and energy consumption, water quality targets, increasing the use of recycled materials, compliance with modern insulation standards and bio-diversity targets), but the targets need not be related to the environment. Examples of non-environmental KPIs include gender diversity in senior management, staff training, payment of a minimum living wage and reducing accident rates.

In the Turkish market, we commonly see two separate SPTs with the margin adjustment being determined pursuant to a margin 'grid' as described above. Recent examples of targets in Turkey include the proportion of the borrower's electricity consumption that is sourced from renewable energy sources, the proportion of new investments allocated to sustainable projects and customer initiatives to raise awareness of sustainability and carbon footprint.

Some sustainability linked loans will not refer to specific KPIs or SPTs and will instead utilise the borrower's overall sustainability score awarded by a third party sustainability rating firm. These overall sustainability scores may be used in place of, or in conjunction with, specific KPIs or SPTs. In the Turkish market we commonly see both approaches; that is, two specific KPIs/SPTs as well as the 'hybrid' approach of one specific KPI/SPT combined with an overall sustainability score.

Reporting and disclosure

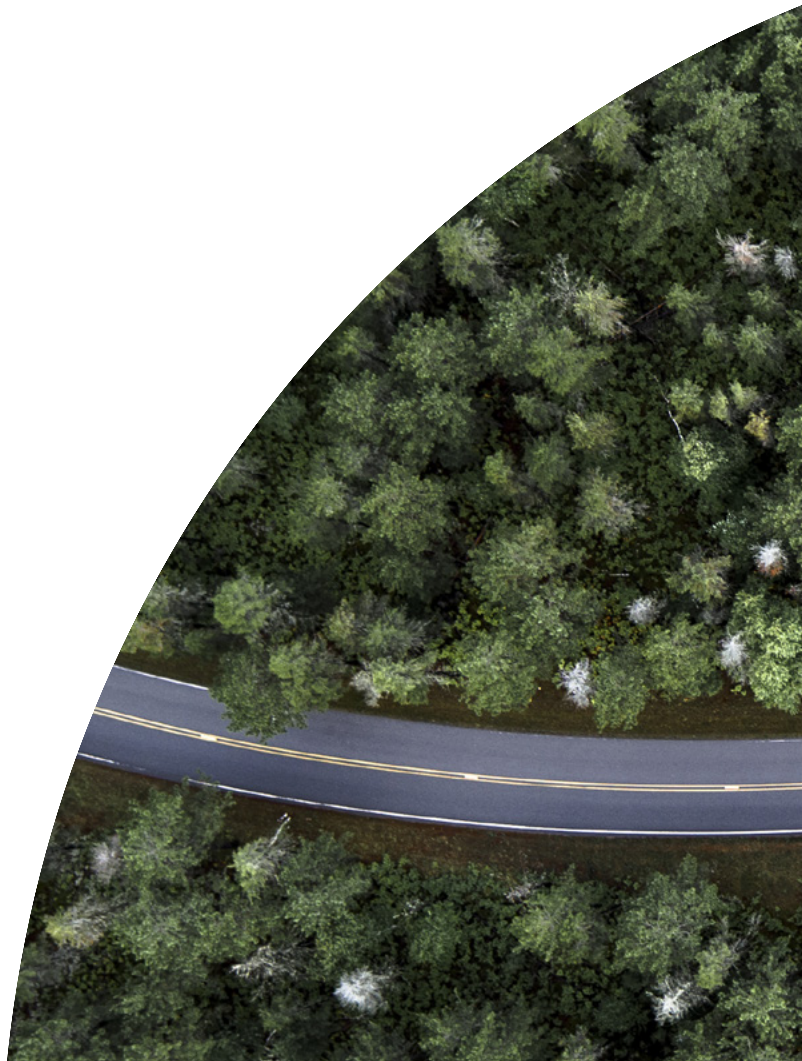
Appropriate reporting as to the borrower's performance against its KPIs/SPTs underpins the integrity of sustainability-linked loans. Aside from an expectation that borrowers report their performance to their lenders at least annually, there is currently no universally accepted methodology for reporting on performance against KPIs/SPTs. At present, reporting tends to depend heavily upon the nature of the KPIs/SPTs but this may change over time, with the EU taxonomy for sustainable activities and the Sustainable Finance Disclosure Regulation expected to have a particular impact.

In addition to reporting to their lenders, in the interests of transparency and with a view to maintaining the integrity of sustainability-linked loans as a product, borrowers are also encouraged (but not required) to publicly report information relating to their SPTs. Some regard detailed public reporting as being inconsistent with the 'private' nature of loan transactions, while others regard it as an important safeguard for the integrity of the product in the context of a market which, relative to the public bond market, is considered opaque. We expect this to remain an area of focus as the market and regulatory landscape continue to evolve.

For Turkish loans, borrowers typically report on their performance by delivery of an agreed form 'ESG or sustainability compliance certificate' on a quarterly or semi-annual basis. In some cases, Turkish borrowers have also agreed to publish certain information relating to their performance on their website and/or in their annual report.

Verification

The LMA's SLLP now require borrowers to seek external verification of their performance against the targets. This verification may be in the form of an independent audit or assurance statementissued by an auditor, environmental consultant, ratings agency or other suitably qualified external party. External verification by auditors or other suitably qualified third parties is common in Turkey.

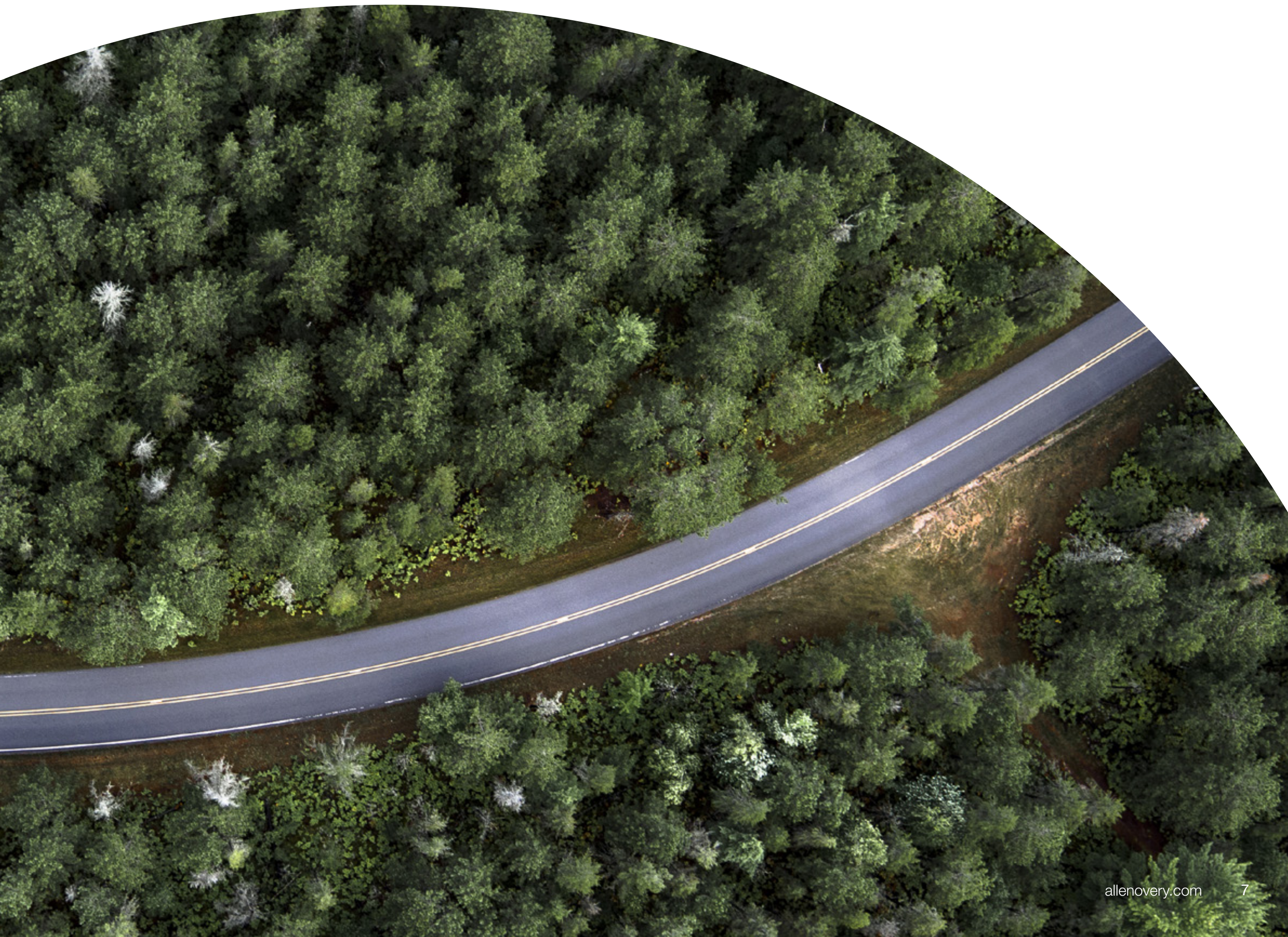


What happens if the borrower fails to meet its targets or fails to report?

Normally (in Turkey as well as more widely) the only consequence is that the highest margin applies; and there is generally no event of default or drawstop that would arise as a consequence of a borrower's non-compliance with the relevant SPTs or reporting requirements. Such non-compliance is often specifically carved out from the events of default.

Sustainability-linked loans are sometimes criticised for this lack of "teeth", though the counter-argument is that a corporate borrower would be highly reluctant to risk a default on their core loan financing that might be due to events that are partly outside their control, and they would also be discouraged from setting ambitious SPTs if the consequence of non-compliance was an event of default.

Reputational implications associated with failing to report will be an important consideration (and deterrent) for most borrowers.



Emerging talking points

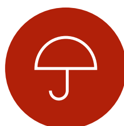
The global sustainability-linked loan market is constantly evolving with ‘refinements’ regularly being discussed on new deals. Set out below are some examples of discussion points arising on recent deals in the European loan market. To date only the final point has surfaced in the Turkish market but it is expected that evolving trends in the European loan market will be highly be persuasive in the Turkish market.

Charitable donations

Primarily to avoid negative publicity from being seen to profit from meeting (and/or failing to meet) sustainability objectives, the borrower may agree to donate an amount equivalent to any margin reduction to charity and/or lenders agree to donate an equivalent to any margin increase to charity.

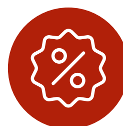
Sustainability payments

In some cases, the amount equivalent to the margin reduction is not paid to charities, with the borrower agreeing instead to direct it towards its own sustainability objectives.



Significant or severe controversy events

In a small number of recent deals, if there is a significant event with an adverse ESG impact (sometimes called an “ESG Event” or “ESG Controversy”) that is categorised as high or severe, any margin adjustment will not apply even if the required KPIs (which may be unrelated to the event) are complied with. Ultimately, this is an anti-embarrassment clause for the lenders and borrower, and seeks to reduce the risk of green-washing.



Borrower’s choice whether to use ESG provisions

In some transactions the borrower can ‘opt out’ of setting annual targets or delivering ESG compliance certificates (ie ‘switch off’ the ESG features). In some cases where this provision is included there is no consequential margin adjustment.

Impact of acquisitions and disposals

How should acquisitions or disposals affect KPIs? Some in the European loan market include specific provision for targets and KPIs to be adjusted – others don't. How these adjustments work (and whether they are required) depends on the nature of the borrower's business and the agreed KPIs.

Role of ESG/Sustainability Co-ordinator

The role of the lender(s) who undertake the ESG/Sustainability Co-ordinator role is becoming the subject of more attention in documentation. Lenders are becoming more aware of the potential liability, whether legal or reputational, that could attach to this role. An obvious concern would be where a lender helps structure a set of SPTs for a given loan and it is subsequently revealed that the underlying information was flawed or manipulated in some way. Accordingly it is becoming more standard for some protective language to be added to documents to recognise this, though the scope of those protections still varies.

Conclusion

Sustainability-linked loans are expected to remain a hot topic in the Turkish loan market and to remain high on the agenda of large Turkish companies and financial institutions. With several sustainability-linked loans having already hit the market in Turkey there now exists a limited degree of market practice that can be used as a benchmark as the market continues to evolve.

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