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Sustainability-linked loans in Russia: a hot market

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Introduction

When it comes to sustainable lending, the Russian loan market is punching above its weight. Many of Russia's leading corporates have raised ESG or sustainability-linked loans (in some cases, multiple loans) over the last couple of years, in a trend that continues to rapidly gather pace amidst the increased focus on Environmental, Social and Governance (**ESG**) matters by regulators, shareholders, investors and wider society.

For many Russian corporates, sustainability-linked loans now comprise an important component of their wider sustainable development strategies and present an opportunity to enhance both their financial and reputational position with investors and customers.

As a product that is still in its relative infancy globally, market practice with respect to sustainability-linked loans continues to evolve across the globe. In this note we provide an overview of the key features of sustainability-linked loans, some of the emerging global trends and how those trends are playing out locally in the Russian 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. In Russia, we have seen sustainability-linked loans used for a variety of purposes across a wide range of sectors, including metals and mining, fertilizers, petrochemicals, energy, financial services and aviation. 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 (in particular tapping into the strong appetite among international banks to invest in Russian sustainability-linked loans, as evidenced by several deals to date being over-subscribed); and

– promoting sustainable long-term growth and profitability.

Regulatory aspects

Whilst the Russian government, the Central Bank of Russia and development institutions have been active in drafting national regulations relating to sustainable finance more generally, there are currently no regulations in Russia which specifically regulate sustainability-linked loans.

To date, the regulatory focus in the sustainable finance sphere has primarily been with respect to:

– recommendations by the Central Bank of Russia for public joint stock companies to disclose how they take into account ESG-related matters;

– the development of new issuance standards for securities, which also cover green and social bonds (but not loans). The Moscow Exchange already has a sustainable development sector consisting of three independent segments: green bonds, social bonds, and national projects;

– a new law regulating greenhouse gas (**GHG**) emissions which was recently enacted in June 2021. The goal of this law is to create a carbon regulation mechanism and infrastructure to raise funding for climate projects. It also provides for (i) the introduction of a step-by-step model for regulating GHG emissions without taxes and mandatory payments; (ii) mandatory GHG reporting for major issuers; and (iii) the establishment of a legal basis for carbon trading;

– the Russian Government in July 2021 adopted an order establishing the goals and directions of sustainable development (**Sustainable Development Goals**). The decree also contemplates the definitions of green project and transition project; and

– for the purposes of implementation of the Sustainable Development Goals, the Russian Government in September 2021 adopted a decree that contemplates a Russian model of taxonomy, which is an important document for green projects. It also provides for terms and conditions for recognising loans and bonds as financial instruments aimed at financing the sustainable development projects.

The heavy involvement of international banks in the Russian sustainability-linked loan market means that the rapidly evolving sustainable finance regulatory landscape in Europe is likely to be highly influential in Russia.

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 (whether that be for a vanilla corporate loan, a pre-export financing or some other type of loan) 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 Loan Market Association (**LMA**) has published (and recently updated in May 2021) a 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 Russian 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 Russia), 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 five basis points upwards or downwards being relatively common in corporate loans. For Russian deals it is not unusual to see more substantial adjustments, with the adjustment occurring quarterly, semi-annually or 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. It is not uncommon to see multiple SPTs with the margin adjustment being determined pursuant to a margin 'grid' as described above.

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 not always required for Russian loans.

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.

Recent examples of ESG targets in Russia include:

– reduced greenhouse gas and atmospheric emissions;

– reduced carbon footprint per unit of production;

– reduced water consumption;

– increased volume or proportion of production from recycled materials; and

– improved safety record.

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 are commonly used in Russia and may be used in place of, or in conjunction with, specific KPIs or SPTs.

Reporting and disclosure

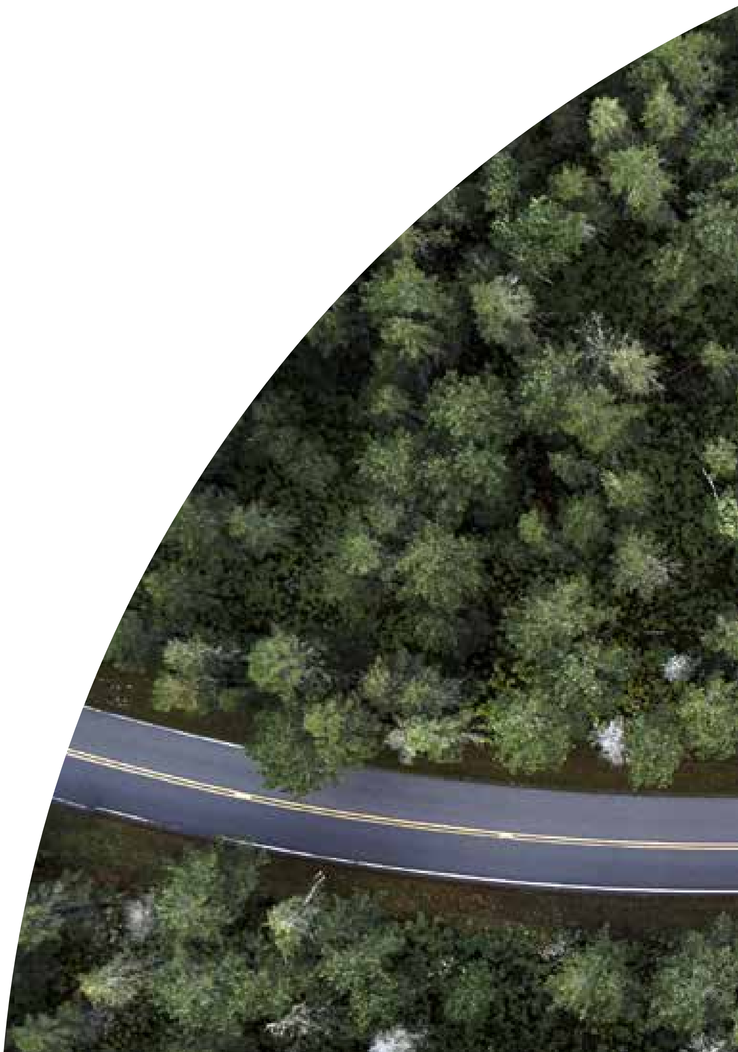
Appropriate reporting as to the borrower's performance against its KPIs/SPTs underpins the integrity of sustainability-linked loans. Aside from an expectation that borrowers report their performance to their lenders at least annually, there is currently no universally accepted methodology for reporting. 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 Russian loans, borrowers typically report on their performance by delivery of an agreed form 'ESG or sustainability compliance certificate' on a quarterly, semi-annual or annual basis. In some cases, Russian 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 statement issued 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 Russia.



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

Normally (in Russia 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.

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

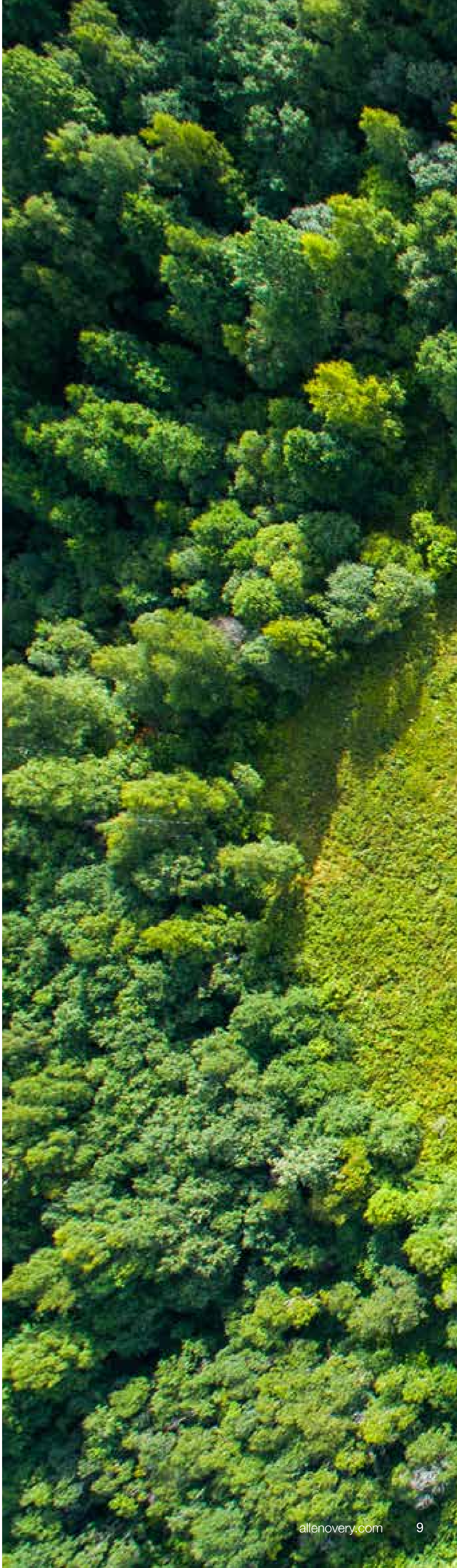
In some transactions, the borrower can 'opt out' of setting annual targets or delivering ESG compliance certificates (ie 'switch off' the ESG features). In some cases where this provision is included, there is no consequential margin adjustment.

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 Russian loan market and to remain high on the agenda of large Russian companies. With a significant number of sustainability-linked loans having already hit the market in Russia, there now exists a degree of market practice that can be used as a benchmark as the market continues to evolve.

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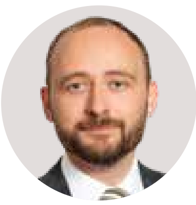

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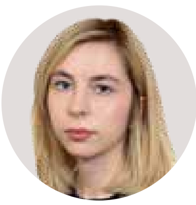

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