BCLP. Client Intelligent

Insights

"THE REPUTATION OF EVERYONE INVOLVED IS AT STAKE."

Nov 03, 2022

SUMMARY

Will unsustainable companies have difficulty accessing financing in the future? Banks and financial institutions are increasingly offering financing based on ESG criteria. Financing is frequently not granted where there are risks of climate damage, CO2 pricing risks or risks of human rights violations in supply chains. Sandra Anne-Marie Gaidies and Andrea Schwaiger discuss the significant changes in the world of SME financing.

SAMG – Sandra Anne-Marie Gaidies
AS – Andrea Schwaiger
VCD – Viola C. Didier

VCD There are now several forms of green financing… What are the common terms one should know about in this area?

SAMG Sustainable finance generally describes more than just green loans. Not only ecological aspects are considered when offering loans. Also the wider context of sustainable economic activity involving all ESG aspects is part of the attention. On the one hand, one could structure a specific project or asset to qualify as "green" or – as a particularly interesting strategy for small or mid-size enterprises (SMEs) – categorise a company's general business conduct as sustainable and thus qualify as "green".

The means of financing which are available for green projects such as (a) wind farms or (b) green assets like energy efficient buildings are strictly bound to one specific propose. The financing structures we usually see here are green loans, green bonds or green "Schuldscheindarlehen". These forms of financing are not particularly interesting for SMEs because they are restricted to a specific purpose. Furthermore, green bonds and green "Schuldscheindarlehen" are more attractive to investors in capital markets, especially due to the high financing volumes. SMEs simply do not have access to this market for green capital because of their legal structure.

VCD Could you give us an overview of the current options for sustainable financing specifically available to SMEs?

SAMG SMEs primarily rely on debt to meet their financing needs – typically through classic bilateral revolving facilities or term loans. They require the greatest possible flexibility and affordable operating funds at their disposal. In a classic corporate funding scheme, one looks primarily at a company's economic parameters, assesses the credit risk and sets the financing costs accordingly. Simply, the better the economic performance is, the better the financing conditions. Studies have shown however that sustainable aspects within a company offer an advantage because they have a positive effect on the company's economic performance and thus improve its creditworthiness. The consideration of ESG criteria in corporate financing can therefore have a beneficial impact on the pricing structure.

AS That's right. A sustainable focus on the environment and climate protection has allowed SMEs acquire lower interest loans through the subsidy programs of the KfW for some time now.

ESG linked loans – also known as sustainable linked loans or positive incentive loans – are a new alternative for accessing low interest operating funds. Larger companies are already taking this approach. It is not about ticking all of the ESG boxes, but rather arranging bespoken criteria with the financing partners based on agreed KPIs in advance. The market relies on guidelines such as the Sustainable Linked Principles of the LMA, LSTA and APLMA.

VCD What do these Sustainable Linked Principles specify exactly?

AS Basically, the principles lay out five steps for setting up a financing structure. First, the evaluation criteria, the so-called KPIs, are selected. These KPIs should be measurable, relate to the core business of the company and reflect its corporate strategy. In addition, they should include quantifiable benchmarks. In other words, they should be comparable to some accessible standard. The principles contain a list of potential KPIs. This list is indicative and provides possible examples, but it is not exclusive.

As an example for "E", if a company uses energy from renewable sources, the portion of its sustainable energy use is measureable and may be used as a KPI. For "S", a focus on diversity and inclusion can be measured for example by identifying the number of women in leadership roles.

The next step is the calibration of sustainability performance targets. These goals should be ambitious and based on modern scientific developments, but they should also be achievable.

The third step involves connecting these sustainability performance targets with the loan conditions, for example with the interest margin. If sustainability goals are reached, the interest rate is reduced. If they are not reached, the interest is increased.

Reporting is another key element. As with classic financial indicators, companies are required to inform their creditors of their performance in relation to the progress of their goals at regular agreed intervals.

The final step is the independent and external verification of the performance level. This evaluation could be conducted by an external rating agency for example.

VCD It seems like the world of SME financing is changing significantly. Do you think that in the future, banks will be looking at how sustainable and future oriented their customers are in all loan negotiations?

AS We've only seen ESG linked loans on the German market since 2019. In 2020, there were about 12 such loans. Demand will increase however, since the Corporate Sustainability Reporting Directive (CSRD) will require around 15,000 German companies to carry out sustainability reporting; previously only 500 German companies were required to carry out sustainability reporting.

SAMG The collection of the data will be a challenge for all kinds of companies – not just SMEs. If the data have already been collected for sustainability reporting purposes and the appropriate strategies are already being pursued, the path to financing through ESG linked loans is much easier. We would view this more as an opportunity for SMEs, which are typically traditional family owned businesses who are facing the challenges of the changing times.

AS In addition, for some time now banks have been required under the Disclosure Regulation to report on their sustainability strategy and financial products. The reputation of everyone involved is at stake. It would be appreciated, when banks would set financial incentives by offering lower cost refinancing opportunities. That would accelerate the expansion of the market for sustainability linked corporate loans.

VCD What happens if companies ignore ESG criteria?

AS Simply, if companies ignore the sustainability aspect, they will not have access to favourable sustainable financing. If sustainability is generally neglected and this results in poor economic performance, then it may become difficult to find financing at all.

A sustainable corporate strategy requires establishing new procedures, creating infrastructure for data collection, etc. Sustainability therefore requires significant investment and extensive renewal. In short, sustainability is exhaustive and time consuming. However, the long-term benefits will ultimately pay off. Banks will be able to meet the necessary financing requirements.

VCD To put it succinctly – reduced sustainability increases loan costs. Improved sustainability lowers the interest rate. Should sustainability performance targets really be linked to financing? Do you see any risks?

SAMG You can currently expect to see an interest rate reduction of three to five basis points in corporate financing models taking an ESG linked approach. This may not appear to be very much at first, but in the current environment of increasing interest rates, every basis point counts.

As mentioned previously, a non-sustainable company will often fail to meet the economic criteria. Sustainable business models have a positive effect of performance. Banks have therefore already indirectly been taking sustainability aspects into their credit risk assessments.

The new development is merely placing the focus directly on sustainability and linking it to the financing conditions. This creates incentives for businesses to actively pursue sustainable strategies and contribute to the common well-being of society. Data collection is a challenge, but this applies to all companies, not just SMEs.

AS In conclusion, improving sustainability is no longer merely a means to improve one's reputation. On the other hand, if companies fail to implement the agreed and advertised sustainability KPIs, they may face allegations of "greenwashing". Such allegations are difficult to deflect and may come back to reflect on the financing partners as well.

VCD Thank you for the interview!

This interview was originally published in the October issue of German ESG Magazine (ESGz - Fachzeitschrift für Nachhaltigkeit & Recht).

MEET THE TEAM

Sandra Anne-Marie Gaidies

Frankfurt

sandra.gaidies@bclplaw.com
+49 (0) 69 970 861 279

Andrea Schwaiger

Frankfurt

andrea.schwaiger@bclplaw.com
+49 (0) 69 970 861 245