GOVERNANCE: ESG IN AVIATION FINANCE (GLOBAL)

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Legal Briefings

INTRODUCTION

WHAT IS ESG AND HOW DOES IT RELATE TO FINANCING?

Environmental, social and governance (ESG) factors are a set of criteria which corporates, their creditors and other stakeholders are increasingly taking into account when making investment decisions. ESG factors cover issues such as climate change, raw material use and pollution (environmental), human rights, employment rights and equality (social) and transparency, audit and executive pay (governance).

There is currently no universal set of ESG criteria, with multiple bodies providing different guidelines or principles for what constitutes an ESG compliant investment. In addition, there are a number of ESG rating agencies (such as Vigeo Eiris or Sustainalytics) whose role is to certify ESG compliance of a specific transaction (usually by issuing an ESG opinion).

Broadly speaking, there are two main types of ESG financing: (1) those that require the proceeds of lending to be used for a specific sustainable purpose or project (these products are often referred to as “green”) and (2) those that require the borrower to achieve certain ESG targets within its wider business in exchange for pricing benefits (these products are often referred to as “sustainability-linked”).

ESG IN AVIATION FINANCE

RECENT DEVELOPMENTS

Until recently, there was often a perception that any investment in aviation (let alone an aircraft finance transaction) could not be ESG compliant because of environmental concerns regarding the industry's contribution to carbon emissions. However, attitudes seem to be shifting as there have now been a number of green or sustainability-linked financings involving airlines, lessors and airports within the past year.

In December 2019, Deutsche Bank closed the first green commercial aircraft financing with lessor Avation in respect of an ATR 72-600 aircraft on lease to Braathens, the Swedish regional airline.[i] The ESG certification of the loan was linked to the Loan Market Association's (LMA) Green Loan Principles[ii], with the primary ESG element being the replacement of the airline's fleet of older regional jets with more fuel-efficient turboprops (thereby reducing the airline's overall environmental impact). Although this was the first reported ESG transaction in the aircraft finance space, there have also been a number of other reported ESG financings within the wider aviation sector.

Examples include the sustainability-linked loans to JetBlue[iii] and Sydney airport[iv] respectively (in each case structured by way of a revolving credit facility), a green bond issuance by ANA to finance a new training centre in Tokyo[v] and a green loan to Etihad to finance expansion of the Etihad Eco-Residence, a sustainable apartment complex for the airline's cabin crew.[vi] The ESG credentials of the Sydney airport transaction were based on the LMA's Sustainability-Linked Loan Principles[vii], whereas the ANA and Etihad deals were linked to the UN's Sustainable Development Goals.[viii]

Furthermore, it was recently reported that major lessor Avolon might look to offer more attractive lease rates to airlines with higher ESG ratings.[ix] Whether this will materialise into meaningful industry-wide practice remains to be seen, however it is clear that lessors and other industry participants are under increasing pressure from investors and other stakeholders to place more emphasis on ESG strategy.

ESG has also gained the support of the wider aviation finance community, with industry body the Aviation Working Group (AWG) recently establishing a working group to coordinate efforts in developing ESG initiatives specifically relating to aviation finance and leasing.[x]

COVID-19 AND BEYOND

THE OUTLOOK FOR ESG IN AVIATION FINANCE

The key drivers of growth in ESG financing within the aviation sector going forward are likely to be:

1. Increased governmental and regulatory pressure – the development of ESG initiatives will be linked to increased regulation of environmental issues through multilateral legal frameworks such as ICAO's Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), in conjunction with existing schemes such as the EU Emissions Trading System (ETS)[xi]

2. Reputational considerations – this may become increasingly important as stakeholders and consumers alike become more aware of a company's ESG rating or performance relative to its peers

3. Pricing benefits for borrowers – whilst these appear to be marginal for the time being, this could change in the future as the market develops

4. Access to a wider pool of investors who require ESG certification – although this is currently fairly limited in the context of aviation finance, aviation has attracted a growing number of institutional investors in recent years who are more likely to place greater emphasis on ESG than traditional aviation lenders or lessors

Furthermore, the acute impact of the Covid-19 crisis could act as a further catalyst for the development of ESG-linked products in aviation finance. Airlines are now retiring older and less fuel-efficient aircraft earlier than planned (especially quad-engine aircraft such as B747s, A380s and A340s).[xii] In addition, many airlines are currently expecting to emerge from the Covid-19 crisis as leaner businesses, in most cases operating with reduced capacity, a more streamlined route network and with an even greater focus on cleaner, quieter and more fuel-efficient aircraft. This means that airlines are likely to attract higher ESG ratings following the rationalisation of their fleets, potentially unlocking further opportunities to participate in ESG financings when market conditions improve.

There have also been unprecedented levels of state aid to airlines during the current crisis, which in some cases have been made conditional on compliance with sustainability targets. For example, the French government's €7 billion financial support package for Air France is reported to be conditional on the airline cutting carbon emissions and reducing domestic flights.[xiii] Similarly, the Dutch government's proposed €2-4 billion support package for KLM requires the airline to contribute to sustainability and noise-reduction initiatives, including the reduction of night flights and cutting CO_2 emissions.[xiv] Such governmental interventions, expressly linked to sustainability as a key policy objective, may also have the effect of accelerating the emergence of further ESG financing opportunities within the sector as airlines are forced to improve their ESG credentials.

However, the growth of ESG financing within the aviation sector (and more generally) will not be without its challenges. Notably, some have queried whether, from a borrower perspective, the economic benefit of ESG compliance (currently in the form of modest margin reductions) will offset the costs of monitoring and reporting on ESG performance, as well as obtaining ESG opinions to verify compliance with ESG targets.

In addition, ESG financings in the sector will also need to overcome negative market perceptions that such transactions constitute "greenwashing" given that aviation has traditionally been viewed as a polluting industry. For example, the new EU Taxonomy Regulation (EUTR) seeks to prevent “greenwashing” by introducing a harmonised set of criteria to determine which products can be marketed to investors as environmentally sustainable. The sector-specific requirements of the EUTR are due to be implemented through “technical screening criteria” under delegated legislation to be adopted between the end of 2020 and the end of 2022. Although aviation is not currently addressed by the technical screening criteria in the final report published by the EU Technical Expert Group (TEG) on Sustainable Finance, the TEG has recommended that aviation should be addressed by the EUTR in the future given the significance of emissions from the sector.[xv]

FURTHER INFORMATION

Herbert Smith Freehills’ finance practice is at the forefront of advising on ESG issues and works closely across all offices to help deliver robust high quality advice to clients. From issuing bonds to fund the development of renewable energy projects to raising debt that satisfies issuers’ environmental policies and investors’ ESG mandates, our finance specialists have the experience to successfully support you when accessing funding options. Clients we have supported in this growing area range from blue chip corporates and project companies to financial institutions and government departments.

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[i] Deutsche Bank provides first green financing of commercial aircraft, DB.com

[ii]Green Loan Principles, LMA website

[iii] JetBlue signs loan linked to ESG goals, FT

[iv]Sydney Airport successfully delivers innovative Sustainability Linked Loan, Sydney Airport website

[v] ANA HOLDINGS Becomes World's First Airline to Issue Green Bonds, ANA HOLDINGS website

[vi] Etihad becomes the first airline to raise funds tied to United Nations sustainable development goals, Etihad website

[vii] Sustainability Linked Loan Principles, LMA website

[viii] Sustainable Development Goals, UN website

[ix] Avolon CEO says greener airlines should pay less to lease planes, Reuters

[x] AWG establishes working group on ESG and aviation finance, AWG website

[xi] Global airline CO2 scheme will supplement, not replace EU carbon market: Commission, Reuters

[xii] Analysis: Will Covid-19 kill off the quad-jet?, Air Finance Journal

[xiii] Air France must cut emissions, domestic flights for aid: minister, Reuters

[xiv] Government prepares financial support measures for KLM, Government of the Netherlands

[xv] Taxonomy: Final report of the Technical Expert Group on Sustainable Finance, European Commission

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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