HERBERT SMITH FREEHILLS

THE GROWING IMPORTANCE OF SOCIAL LOANS FOR PROJECT FINANCE

24 December 2021 | Australia
Legal Briefings – By **Jon Evans, Erin Wakelin and Nick Gillies**

The last five years has seen a global boom in sustainable financing, primarily driven by green loans and bonds, and sustainability linked loans (SLLs). Growth in this area has been linked to a desire to align financing transactions with a broader imperative to improve the environmental impact of businesses and projects.

More recently, borrowers, investors and financiers have also focused on improving the wider social impact of their businesses. This attention to the social aspects of 'ESG' is the product of heightened expectations of stakeholders and society at large, and the growing realisation that corporates can play a vital role in positively addressing social inequalities. This shift in mindset is reflected in the emergence of social loans and SLLs where performance is linked to social outcomes (which, in this article, we will call social SLLs) into mainstream financing transactions. While green loans and SLLs are more easily linked to project financing transactions, particularly in areas such as renewable energy, opportunities for project sponsors and financiers on the 'social' side of sustainability financing are growing.

INTRODUCTION TO SOCIAL LOANS AND SOCIAL SLLS

SOCIAL LOANS

The Loan Markets Association (**LMA**), Asia Pacific Loan Markets Association (**APLMA**) and the Loan Syndications and Trading Association (**LSTA**) published the Social Loan Principles (**SLPs**) in April 2021. The publication of the SLPs represented a considerable step forward for mainstream acceptance of social loans. The SLPs provide a voluntary, non-binding and high-level framework for social loans. For a loan to be characterised as a 'social loan' under the SLPs, it must meet the following criteria:

1. **Use of Proceeds**: The loan proceeds must be applied toward a 'Social Project'. This is the most important factor in determining whether a loan can be properly considered a social loan under the SLPs. The non-exhaustive list of 'Social Projects' in the SLPs includes projects in the health and education sectors, affordable housing, access to essential services and other basic infrastructure projects, and projects aimed at facilitating socioeconomic advancement, increasing employment and improving food sustainability.

2. **Process for Project Evaluation and Selection**: Borrowers must disclose the social objectives of the project and the process underpinning its categorisation as a 'Social Project'.

3. **Management of Proceeds**: Loan proceeds must be quarantined in a separate account, to ensure that they are only applied for the relevant 'Social Project'.

4. **Reporting**: The Borrower must report (typically annually) on how loan proceeds have been used to show compliance with the use of proceeds principle.

SOCIAL SLLS

SLLs are financing instruments which include agreed sustainability-linked targets. If the borrower meets the agreed targets it will unlock a pre-agreed benefit (e.g. a margin discount), with failure to meet the targets resulting in a pre-agreed cost (e.g. usually an increased margin). These targets incentivise borrowers to set and achieve meaningful and ambitious targets that seek to address key sustainability issues in their business or sector.

The LMA, APLMA and LTSA Sustainability Linked Loan Principles (**SLLPs**), published in May 2021 set out the following Core Components:

- **KPI selection**: KPIs must be credible, relevant, core and material to the borrower's overall business and address relevant ESG challenges in the relevant industry sector.

- **Calibration of sustainability performance targets**: Sustainability performance targets (**SPTs**) should be ambitious, represent a material improvement beyond 'business as usual' and, where possible be compared to a benchmark. Where available, lenders will usually require benchmarking against the borrower's historical performance, although benchmarking against the borrower's peers / industry standards may also be possible. Second Party Opinions verifying the appropriateness of, and the methodology for, determining SPTs are also encouraged.

- **Loan characteristics**: The loan should incentivise the borrower to achieve the relevant

SPTs.

- **Reporting**: Borrowers are encouraged to report against their SPTs publicly, at least annually.
- **Verification**: Annual independent and external verification of the borrower's performance by an appropriately qualified reviewer is required.

EMERGENCE OF THE SOCIAL LOAN

In the first nine months of 2021, the total value of issued social bonds was US$171.6 billion, a 96% increase compared to 2020 levels.[1] While government social bond issuances no doubt inflate the social bond market beyond what is achievable for private social loans, social bond market data is indicative of the increased appetite for financing arrangements that facilitate positive social outcomes.

SOCIAL LOANS, SLLS AND PROJECT FINANCING

OPPORTUNITIES FOR USING SOCIAL LOANS AND SLLS IN PROJECT FINANCINGS

To date social loans have been the main driver of 'social' transactions in the project finance space. As the 'use of proceeds' requirement for social loans relates to financing specific social projects, this construct can be relatively easily applied to financing projects categorised in the SLP as 'social' without a significant cost or compliance burden for borrowers and financiers. One drawback in terms of the use of social loans however seems to be for projects which are only partially social (e.g. mixed use projects for affordable housing) or where proceeds are only partially applied toward the social project.

Traditional bankability limitations for these types of projects will also continue to apply, meaning the application of the SLPs won't solve the financing issues facing many social projects, or deliver a pricing benefit which might increase the viability of some social projects.

There does however remain a significant opportunity to incorporate 'SLLs with social elements' into project financings for a broad range of projects which do not meet the 'use of proceeds' requirement under the SLPs. While it is currently the case that social SPTs only supplement traditional 'green' SPTs – and measuring performance only against social SPTs is not common – this may change in response to stakeholder expectations.

AUSTRALIAN EXAMPLES OF SOCIAL LOANS AND SOCIAL SLLS IN PROJECT FINANCE

The recent A$2.2 billion refinancing of Australia's largest hospital project, the new Royal Adelaide Hospital (**RAH**), is the only example of a social loan under the SLPs in the Australian project finance market. RAH is the first Australian infrastructure project or public private partnership (**PPP**) to be financed as satisfying both the Green Loan Principles[2] and the SLPs. The refinancing illustrates what will become an emerging trend in the Australian market – existing operational projects falling under a social project category in the SLPs will increasingly refinance under the new SLP framework. This trend started in the green loan sector, where project vehicles have been keen to position their financing under the sustainable finance umbrella for their first refinancing.

On the social SLL side of the ledger, the privatised NSW Land Registry Services (**LRS**) acted as borrower under a $300 million social SLL in August 2021. Financial incentives were available to the LRS under its financing for developing and implementing a Reconciliation Action Plan, setting employment targets for Aboriginal and Torres Strait Islanders and procurement from Aboriginal and Torres Strait Islander businesses. As LRS has identified reconciliation as a key priority, these targets are material to, and intended to align with, LRS's core business.

KEY CONSIDERATIONS FOR BORROWERS AND LENDERS IN SOCIAL SLLS

SOCIAL SLLS GENERALLY

The highly publicised growth in sustainable financing has generated significant interest from new borrowers and lenders considering entering the market. However, there are a range of considerations relevant to proceeding with a sustainable financing transaction, and in particular a social loan or SLL with social aspects in project financing.

BESPOKE NATURE

The social SPTs incorporated into SLLs are inherently bespoke. SPTs are tailored to address the most pressing social issues facing the relevant borrower or sector. The nature of social targets means that there are qualitative elements that require a greater understanding of the underlying social issue. Performance against social SPTs is not as readily assessable as objective environmental metrics.

This sentiment is shared by David Jenkins, Global Head of Sustainable Finance at National Australia Bank, who notes that 'each SLL transaction is bespoke and each deal is different. The challenge here is that this is currently a very new, evolving and specialised area. These KPIs are not as easy to quantify as traditional credit rating metrics'.

This issue is compounded by the fact that the market acceptance of social KPIs is still developing; both in terms of which KPIs are appropriate and how performance is assessed against SPTs. Additionally, borrowers may lack the institutional knowledge and resources to accurately measure performance against social KPIs.

As the market matures, we expect more consensus regarding appropriate KPIs and SPTs for different project sectors. However, a universally recognised approach for project financings remains doubtful.

MEANINGFUL TARGETS

The principal aim of SLLs with social criteria is to incentivise borrowers to actively pursue strategies which meaningfully improve their social impact beyond business as usual. This common thread underlies the SLPs and as such influences the approach of lenders. As Madeleine Harmer, from the Commonwealth Bank of Australia's Sustainable Finance team notes: 'social targets must be additive. We would not want to reward borrowers for achieving something that is already a standard/established community expectation'. Divergence of lender views in this area is also playing out in debate about issues such as whether existing targets can be used, or whether these targets must be newly created for the SLL.

These tensions have been compounded by broader shifts in consumer sentiment toward corporate social responsibility - as both borrowers and lenders compete to garner greater social capital with stakeholders, the dangers of 'social washing' increase. As a result, participants are increasingly looking to guidance from industry bodies and Second Party Opinions for verification of social targets. Lenders are also focusing their resources on robustly assessing the acceptability of social SPTs to avoid the possible reputational risk inherent in providing a benefit for targets which are perceived as unambitious.

We expect convergence around certain industry or sector-wide targets will begin to de-risk this element of social SLLs as the market matures, noting that the breadth and variance in social KPIs and the parochial nature of some social expectations may mean that these will never be wholly homogenous.

Recent examples of SLLs with social aspects go beyond gender, diversity and health and safety. Jonathan Drew, Managing Director of ESG Solutions at HSBC listed mental health support and training as gaining traction, while another source noted the financing for the Heathrow Airport as including a KPI that every person in the Heathrow footprint would be on a living wage, with the penalty for failing to meet this SPT applied to employing people on living wage contracts.

Another risk to the SLL market is the speed with which societal norms and expectations can shift. SLLs must be able to adapt to these shifts; it will become important for borrowers and lenders to continually review targets to ensure they remain culturally appropriate and sufficiently ambitious. Social targets will also not be 'set and forget'; and SLLs should incorporate mechanisms to ensure that targets set now remain appropriate in the future.

ACCURATELY MEASURING PERFORMANCE

While setting appropriate targets is one thing, it is another to develop accurate, objective and reliable approaches to measuring performance. This issue is particularly acute in the SLL market given the prospect of reputational damage if a borrower consistently under-performs (or even considerably out-performs) against its SPTs.

In project financings, this may mean that project vehicles are simply not sufficiently resourced to adequately measure and report performance on the scale required under an SLL.

This also means that lenders have taken on a more active role in SLL transactions including as sustainability coordinators or by mandating external ESG assessments by third party providers such as Moody's, Sustainalytics or S&P. Third party tools have also been utilised by lenders to measure borrower performance, with tools such as the Sustainability Accountability Standards Boards' Materiality Map and the GRESB score being used to both measure and contextualise borrower performance against social KPIs.

While these external and broad-based ESG metrics are useful, the key protection for parties under the SLLPs is the requirement for annual external verification. However, the parties must ensure that this verification process is undertaken independently and by an appropriately qualified verifier.

SOCIAL SLLS AND PROJECT FINANCINGS

While the considerations referred to above apply broadly across the sustainable finance market, the use of social SPTs in SLLs also poses specific issues in the project finance context, given the idiosyncrasies of the project finance structure and the sectors in which borrowers typically operate.

PPPS

As the private sector has increased its focus on ESG performance, so too have governments. Increasingly, bidders for PPPs are required to demonstrate how their bid aligns with the government's ESG priorities, generally by meeting the relevant mandated KPIs.

As an SLL should set targets which considerably outperform the required performance criteria, there is likely to be a cost for achieving those higher targets. There will also be a cost for establishing and maintaining a SLL. These costs are unlikely to be offset by the potential for margin reduction. As a result, a SLL may well increase the bid price, so the question for sponsors will be whether governments will recognise the value of the SLL and potential outperformance of its criteria in evaluating bids and the increase in the tender price.

GREENFIELDS PROJECTS

Another issue is also posed by the idiosyncrasies of a typical project financing structure. Generally, SPTs in SLLs are set by reference to the core business of the borrower and their strategic importance to the borrower's operations. Targets are also set by reference to historical performance of the borrower to ensure that the targets are sufficiently ambitious.

SPVs, which are commonly used in project financing, will not have any historical performance to benchmark performance. Additionally, where relevant to the SPTs, it may be some time before the SPV has any operating history against which it can benchmark its KPIs, as financing typically comes before the project is operational. There is therefore greater risk to a project finance borrower for a greenfields project in setting targets that may be practically unachievable. While benchmarking against other projects in the same sector may be possible, the lack of market precedent in most sectors may mean that extensive use of SLLs for greenfields projects will take time.

SOCIAL TARGETS AT THE CONSTRUCTION STAGE

The construction phase of a project provides a unique opportunity for borrowers and financiers to link social SPTs to their procurement and other contracting arrangements. While these requirements are yet to appear, we expect that social targets may include diversity requirements for subcontractors and site workers, or robust ethical sourcing requirements placed on suppliers.

CONCLUSION

While we have seen considerable growth in sustainable finance recently, the social loan and SLL markets are still in their infancy. The relative novelty of social criteria in SLLs and social loans raises unresolved issues for project financing, particularly in respect of appropriate target setting, accurate performance benchmarking and the risk of social washing.

Additional time and effort will be required to tailor corporate SLL solutions to SPV project financings. However, project financing presents an opportunity for SLLs, both during construction and once operating, as we anticipate social targets will begin penetrating supply chains and contracting arrangements for project financings.

This article was originally published in PFI: www.pfie.com

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1. Refinitiv Deals Intelligence, *Sustainable Finance Review*: *First Nine Months of 2021* (October 2021) 3.

2. See Loan Market Association, Asia Pacific Loan Market Association and Loan Syndications and Trading Association, *Green Loan Principles* (December 2018) available here.

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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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