LMA Loan Market Association

NORTON ROSE FULBRIGHT

Financing Sustainability in Shipping

Shipping plays a critical role in facilitating efficient global trade and underpins the international economy: it is estimated that over 80% of world trade is carried by sea.

There are, however, a number of social and environmental issues which the industry will have to address. For example, whilst shipping is by far the most efficient way of transporting goods, aggregate global shipping emissions are significant, accounting for 2.9% of total global emissions in 2018, with projections suggesting that this could rise in the future.[1]

The maritime industry is aware of both the environmental and social challenges it faces. For example an industry group, The Sustainable Shipping Initiative, identified "7 global trends, the global economy, ocean governance, demand for transparency, the future of energy, sustainability regulation, advancing technology and adapting to climate change all of which will profoundly affect the maritime sector over the next 30 years."[2]

There are multiple opportunities for financial institutions to aid the maritime sector in preparing to meet these global trends, and in this article we shall look specifically at how sustainable finance products are assisting the shipping industry in meeting climate change challenges.

Understanding the Instruments on Offer

There are fundamentally two types of loan instrument on offer to help companies finance their sustainability goals: use of proceeds loans and sustainability-linked loans[3] (SLLs).

Use of proceeds instruments – being green and/or social loans – provide financing for standalone 'green' and/or 'social' projects. SLLs, on the other hand, focus instead on supporting a borrower to improve its sustainability performance, via the achievement (or not) of predetermined sustainability performance targets (SPTs). As a result, the proceeds of SLLs may be used to finance any kind of business activities that the borrower is pursuing, be they project based, acquisition based and so on.

In some situations, companies may choose to follow a combination of the use of proceeds and SLL instruments on offer. In doing this, they must make sure they adhere to the requirements of both frameworks in place.

Whilst green loans can be, and have been, used by companies active in shipping, their use is likely to increase alongside the technological developments (especially relating to marine fuels) necessary to progress maritime decarbonisation. Due to the inherently flexible nature of SLLs, being borrower-focused, sector agnostic and capable of use across a range of corporate purposes, SLLs tend to be the more favoured instrument at present. As such, we shall focus this article on how best to use a SLL in a shipping finance transaction.

Sustainability-Linked Loans: The Core Components

SLLs are defined as "...any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) for which the economic characteristics can vary depending on whether the borrower achieves ambitious, material and quantifiable predetermined sustainability performance objectives"[4], and which comply with the five core components of the SLLPs.

1. Reducing emissions from the shipping sector (europa.eu).
2. SSI Case for Action – Sustainable Shipping.
3. Each supported by the APLMA, LMA and LSTA's Green Loan Principles, Social Loan Principles and Sustainability-Linked Loan Principles (SLLPs) and supporting Guidance: https://www.lma.eu.com/sustainable-lending/resources.
4. From the SLLP released 23 February 2023: https://www.lma.eu.com/application/files/7316/7967/6350/Sustainability_Linked_Loan_Principles_23_February_2023_v.2.pdf.

1. Selection of Key Performance Indicators (KPIs)

SLLs aim to support a borrower's efforts in improving its sustainability profile over the term of the loan. They do so by aligning loan terms to the borrower's performance, which is measured using one or more sustainability KPIs that can be internal and/or external.

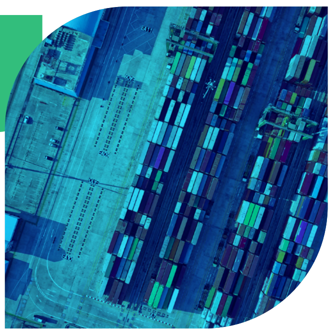
SLLs in the shipping industry have typically focussed on the environment limb, or the 'E' in ESG[5], with many financings setting criteria for vessel emissions or carbon intensity, frequently on a fleet basis. A key element of these emissions-related KPIs is often the annual efficiency ratio (AER) for a vessel. The AER calculates the operational carbon intensity of a vessel by dividing its annual carbon emissions by its total annual deadweight distance. The AER is also used in some of the regulatory developments that have sought to target decarbonisation in shipping.
The International Maritime Organisation (IMO) has introduced the Carbon Intensity Indicator (the CII), a global measure which requires the calculation and reporting of a vessel's AER. A vessel is then given a CII rating depending on how efficient the vessel is, with the criteria for the rating becoming progressively more stringent over time.

Many SLLs use the AER calculation, which all shipowners should be familiar with, and set more stringent targets than the CII regime imposes. Economic benefits, such as margin ratchets, are used as an incentive to meet these KPIs. The KPIs around efficiency are often set at group level, rather than relating to individual vessels.

For example, the $527 million SLL provided to MISC Berhad sets KPIs around an efficiency ratio for the group's gas assets and solutions fleet which, if met, can result in interest rate adjustments.

Similarly, the SLL that Vista Shipping entered into set targets around the fleet's AER and sulphur oxide emissions over a 10-year period, with a margin ratchet mechanism if KPIs are met.

Whilst most shipping SLLs focus on environmental KPIs, there is also scope to set KPIs around social and governance aims. For example, the recent US$200m Navigator Gas L.L.C financing incorporated KPIs linked not only to the environmental performance of its fleet but also to the number of women holding leadership roles within the organisation.[6]



2. Calibration of SPTs

The process for calibration of the SPT(s) per KPI is key to the structuring of SLLs, since it will be the expression of the level of ambition the borrower is ready to commit to.

The calibration of SPTs, particularly those which deal with environmental issues, needs to be carefully considered for shipping facilities. The industry is facing an unprecedented level of change as it addresses the need to decarbonise. The need to change is coupled with the challenge that there is not one set path to decarbonisation: there is still a lack of consensus in the industry about the technology and fuel which is going to be most effective at achieving significant emissions reductions. Regulations have been introduced, both at national and supra-national level, to try to help effect the change that is needed.

For example, the IMO has introduced a number of ESG-related measures which apply, or will apply, to the global maritime sector. These include the CII regime mentioned above: the rating element of this is significant as there is intended to be incentives for those vessels which achieve higher ratings, with remedial action required for those with lower ratings.

In addition, the European Union has introduced a raft of measures in its 'Fit for 55' package, many of which have now been formally adopted. A number of these measures address shipping emissions: for example, the inclusion of shipping in the EU Emissions Trading System (ETS) requires the surrender of allowances which correspond to vessel emissions. The EU ETS will not just apply to vessels flagged in EU Member States: it will apply to all vessels calling at EU ports and so is likely to have a significant impact, logistically and financially, on the industry.

There have also been voluntary measures taken to address the industry's environmental impact, such as the introduction of the Poseidon Principles, which are a bank-led initiative to provide a "global framework for assessing and disclosing the climate alignment of financial institutions' shipping portfolios"[7]. Decarbonisation trajectories are set , and the Poseidon Principles require banks who are signatories to the scheme to assess and disclose the climate alignment of their shipping portfolios against these trajectories.

The SLLPs specify that SPTs should remain relevant and ambitious throughout the life of the loan and since the February 2023 updates[8] these set out that as well as going beyond a 'business as usual' trajectory, SPTs must also go beyond 'regulatory required targets'. Given that new and, in some cases, ambitious, regulatory requirements have been introduced to the industry, the ambit of any SPTs will need to be set carefully to ensure that shipping companies are able to logistically and financially comply with these.

5. Environmental, social and governance.
6. Other ways in which shipping SLLs could be used to encourage gender diversity in the industry are discussed in more detail in the article: https://www.nortonrosefulbright.com/en/knowledge/publications/2881c421/incentivising-gender-diversity-in-shipping-loan-agreements.

The SLLPs now recommend that SPTs be set annually and whilst this means that there is some uncertainty for parties as to how SPTs might develop, particularly for facilities with longer tenors, this ability to consider requirements annually might be a positive development for shipping. In view of the pace of change shipping faces and the fact that there is not, at present, one route to meet emission reduction aims, periodically setting SPTs, which can be adapted as the market moves, might be more sensible than setting SPTs for the full tenor of a loan.

Whilst the SLLPs require SPTs to be set before or concurrently with origination of the loan, this only applies to initial SPTs. Where, due to the pace of change or length of tenor or a shift or acceleration in the market SPTs for latter years cannot be set at origination, they can be set at a later date via an amendment process. This does not impact labelling of the loan at the outset, but instead highlights the inherent flexibility of the instrument to meet borrower/sector needs.

3. Loan Characteristics

A key characteristic of a SLL is that an economic outcome is linked to whether the selected predefined SPT(s) are met.

However, it is important that this potentially positive economic outcome is not perceived as the sole justification for pursuing a SLL. A SLL is a tool to complement a company's sustainability journey, not a means to an end in itself. Furthermore, there are costs associated with SLLs in terms of time (structuring the transaction and ensuring KPIs are material and SPTs are ambitious) and ongoing additional expenses (requirement for external verification mentioned below).

Often shipping finance transactions are made available to special purpose companies to finance one or more specific vessels with a parent company providing a guarantee of the obligations under the facility. Parties will need to consider whether SLLs are better made available at the parent company, or a wider group, level to ensure that SPTs are set at an appropriate and effective level.

4. Reporting

Whilst it is essential that borrowers provide lenders participating in an SLL with up-to-date information to allow them to monitor the performance of SPTs and determine that they remain ambitious, the market should strive for transparency beyond this. Borrowers should be encouraged publicly to report information relating to their SPTs as not only will this aid in establishing a target benchmark across industries but will also act as a further 'check' on themes of materiality and ambitiousness given the widespread interest amongst regulators, shareholders and the general public in sustainability.

The public disclosure of certain ESG information is not entirely new to the industry as a result of initiatives such as the Poseidon Principles. Despite this, the transparency expected under the SLLPs around commercially sensitive information, such as decarbonisation plans, will be novel for some ship owning companies, particularly those which are not publicly listed. However, regulatory obligations, such as the CII regime, will require more information-sharing between industry participants and so greater collaboration and transparency across the sector may become more usual as shipping becomes more sustainable.

7. About - Poseidon Principles for Financial Institutions.
8. Considered in more detail at https://www.nortonrosefulbright.com/en/knowledge/publications/f7c33e1e/what-do-you-need-to-know-about-the-revised-sustainability-linked-loan-principles.

5. Verification

Borrowers must obtain independent and external verification of their performance level against each SPT for each KPI for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the SLL economic characteristics, until after the last SPT trigger event of the loan has been reached.

Whilst the costs associated with this requirement might unwind some of the economic benefits on offer for SLLs, it is important that external verification of performance be obtained. Whilst SLLs are not regulated, they do and will continue to attract interest from regulators, as well as the wider public community. Borrowers and financiers, across a number of industries and not just shipping, are increasingly mindful of 'greenwashing' risk. Removing the third-party verification requirement, and permitting borrowers to 'mark their own homework', the results of which could lead to a margin discount, would create a conflict of interest and could call into question the integrity of the product.

The shipping industry is used to working with classification societies, which are independent organisations that help set and monitor the technical standards for ships, during their construction and operation, to verify data: for example the EU's monitoring, reporting and verification regulations[9] require the external verification of submitted data. As a result, the industry and the classification societies should be well equipped to meet the requirements for third party review of emissions-related KPI performance.

Future Outlook

Sustainability is a pressing issue in the shipping industry: both for shipowners and for their financiers. There is an increased pressure on banks and financial institutions both from trying to meet the decarbonisation trajectory set by the Poseidon Principles (for signatory members) as well as from having to justify their investment choices based on sustainability and environmental risk and to do so in a transparent manner. In addition, investors in listed shipping companies are increasingly expecting to see greater detail on these companies' sustainability targets and evidence that capital has been allocated for ESG-related activity. Regulatory change continues, as national and supra-national regulators pursue policies designed to stimulate a more efficient shipping industry.

As a result, shipping SLLs have grown in popularity and have become an increasingly common way for shipping companies to access finance. We expect to see more SLLs in the maritime sector as financial institutions continue to focus on sustainable financing. Those shipowners who are able to commit to decarbonisation and other ESG objectives are likely to find that they have more financing options in a competitive market than others who are slower to adopt these measures.

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9. REGULATION (EU) 2015/757 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 29 April 2015 on the monitoring, reporting and verification of greenhouse gas emissions from maritime transport, and amending Directive 2009/16/EC.