LMA | Loan Market Association

Guidance on the application of the Green Loans Principles in the real estate finance (REF) investment lending context

Green buildings

October 2020

Important Notice

This Note is intended as an overview and is not intended to be comprehensive. Whilst every care has been taken in its preparation no representation or warranty is given by the LMA as to the accuracy or completeness of the contents of this Note. Most importantly, this Note is not designed to provide legal or other advice on any matter whatsoever.

This guidance note deals with some frequently asked questions in relation to the application of the Green Loan Principles (**GLP**)[1] in the REF investment lending context. This guidance note focuses specifically on green loan funding for green buildings.

1 General

A. What are green loans? Can they be used as part of REF investment lending transactions?

Green loans are any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible Green Projects. The LMA, together with the APLMA and the LSTA, produced the GLP which are a high-level framework of market standards and guidelines, providing a consistent methodology for use across the green loan market. The four core components of the GLP are:

1. Use of Proceeds
2. Process for Project Evaluation and Selection
3. Management of Proceeds
4. Reporting

The LMA, together with the APLMA and the LSTA, has also produced an accompanying document, '*Guidance on Green Loan Principles*'[2], which deals with a number of frequently asked questions in relation to the GLP.

Green loans are not sector specific and can be used in any sector, including on REF investment transactions.

B. Why is the use of green loans in the REF context important?

Buildings are responsible for approximately 40% of energy consumption and 36% of CO2 emissions in the European Union (the **EU**).[3] Around 35% of the EU's buildings are over 50 years old and almost 75% of the building stock is energy inefficient.[4]

In order to reduce emissions and help to meet the net zero 2050 climate targets, which have been set by both the EU and the United Kingdom, emissions reductions will need to be achieved in respect of both new and existing buildings. This will require significant public and private investment aligned to these and other global climate targets, including the Paris Agreement goals and the UN Framework Convention on Climate Change.

Green buildings have the potential to make a substantial contribution to broader climate change mitigation efforts. Climate change mitigation aims to avoid significant human interference with the climate system, and to stabilise greenhouse gas levels in a timeframe sufficient to allow ecosystems to adapt naturally to climate change, ensure that food

2 For more information, please see the Green Loan Principles and the Guidance on the Green Loan Principles.

2 https://www.unpri.org/download?ac=1453 and http://www.sustainablefinance.ch/en/glossary-_content---1--3077.html

3 https://ec.europa.eu/info/news/new-rules-greener-and-smarter-buildings-will-increase-quality-life-all-europeans-2019-apr-15_en

4 https://ec.europa.eu/info/news/new-rules-greener-and-smarter-buildings-will-increase-quality-life-all-europeans-2019-apr-15_en

production is not threatened and to enable economic development to proceed in a sustainable manner.[5] In the buildings sector, climate mitigation has been identified as the deployment and implementation of design strategies, technologies and practices that:

- reduce energy demand and consumption associated with the buildings – from design, construction, hand-over, operation to renovation and end-of-life;
- switch to low- or no-carbon fuels;
- maximise opportunities for buildings to sequester carbon; and
- catalyse behaviour change towards sustainable lifestyles.[6]

Examples of climate change mitigation activities in the real estate sector which may make a positive contribution to climate change mitigation aims include, but are not limited to, innovative use of traditional building materials and design; solar technologies; low carbon heating systems; water efficiency technologies; and energy management and performance technologies.[7]

Finance professionals, including lenders, have a key role to play in catalysing the decarbonisation of the real estate sector and encouraging activities and practices in this sector which contribute to broader climate change mitigation goals. Green loans are an example of a sustainable finance product which lenders may use to channel capital into environmentally sustainable economic activities.

In 2019, buildings accounted for 30% of use of proceeds in relation to green bonds.[8] There is, therefore, already significant demand for green finance solutions in relation to buildings. Further demand for green finance solutions may be driven by increasing market and regulatory pressures to ensure that buildings contribute to broader climate goals.

2 Use of Proceeds

> “The fundamental determinant of a green loan is the utilisation of the loan proceeds for Green Projects (including other related and supporting expenditures, including R&D), which should be appropriately described in the finance documents and, if applicable, marketing materials.”
>
> – Extract from the GLP

A. What is an eligible ‘Green Project’ in the REF investment context?

There is no single definition of what constitutes a Green Project in the REF investment context, or indeed in any other sector as scientific standards, regulations and industry best-practice continue to be developed.

Each financial institution will usually set internal standards or ‘eligibility criteria’ –sometimes set out in a document known as a green finance framework – regarding what they will and will not classify as an eligible Green Project in the REF investment context. Alternatively, the institution may rely on external review or make a case-by-case determination of whether a particular activity or project qualifies as ‘green’. As well as establishing the broad categories for eligibility, financial institutions may set internal technical screening criteria, sometimes by reference to external certifications or standards, to identify those types of projects which they consider eligible for funding under a green REF investment loan.

Borrowers may also produce a green finance framework which will set out, amongst other things, the eligible Green Projects towards which they intend to apply green loan funds and will often include information about their approach to green investment projects, developments and refurbishments more generally. The provision of this framework is not a requirement under the GLP, but its provision prior to completion may help to ensure transparency and mitigate against the risk of greenwashing on any green REF investment loan transaction. Regardless of whether or not a green finance framework is provided, lenders should ensure that the eligibility criteria for Green Projects to be funded under the green REF investment facility are clearly agreed and documented.

Some examples of potential categories of Green Projects which may broadly be funded in the REF investment context include, but are not limited to:

- the acquisition of a green building or portfolio of green buildings/ properties;
- the refinancing of a green building or a portfolio of green buildings; and
- financing of capital expenditure for improving energy performance and water consumption as well as other expenditure relating to the financed building or portfolio of buildings which contribute to climate change mitigation or other environmental goals (i.e. retrofit works).[9]

Where the borrower does not have a designated eligible Green Project at the time of entering into the loan, it may be possible to designate a revolving credit facility as a green loan provided the eligible category (or categories) of Green Projects for which the loan proceeds may be utilised is sufficiently identifiable in the relevant facility agreement and the loan satisfies all four core components of the GLP.[10]

5 https://www.ipcc.ch/site/assets/uploads/2018/02/ipcc_wg3_ar5_summary-for-policymakers.pdf

6 https://www.uncclearn.org/sites/default/files/inventory/unep223.pdf

7 As above.

8 https://www.climatebonds.net/system/tdf/reports/2019_annual_highlights-final.pdf?file=1&type=node&id=46731&force=0

9 For retrofit, please see our accompanying document, ‘Guidance on the application of the Green Loan Principles in the real estate finance (REF) lending context – Retrofit projects’.

10 https://www.lma.eu.com/application/files/7215/8866/8713/GLP_Guidance_V06.pdf

It should be noted that the criteria for green loans focus on the eligible projects rather than on the borrower itself. Where the focus of the loan is on the borrower's sustainability profile, use of the sustainability linked loan framework may be more appropriate. It should nonetheless be noted that the GLP recommend that borrowers clearly communicate to lenders their overall environmental sustainability objectives, and how they intend to identify and manage potential environmental and climate risks associated with proposed projects.[11]

B. Is there a universal definition of what constitutes a green building/property?

According to the World Green Building Council, a green building is "a building that, in its design, construction or operation, reduces or eliminates negative impacts, and can create positive impacts, on our climate and natural environment".[12] At present, however, there is no universally applicable standard for determining what constitutes a green building.

Whilst there is no universal standard as to what can be classified as a green building, there are various external standards and certifications which may be used to help measure and identify green buildings

It should be noted that a building which may be classified as green at the beginning of a loan term may cease to meet the requirements for being green during the loan term. Borrowers and lenders may therefore wish to agree a mechanism for assessing the eligibility of a particular property where the allocated funds are intended to be drawn after the completion date (for example, by reference to its green finance framework; by requiring the delivery of additional conditions precedent prior to drawdown of the additional tranche of funding; and/or by requiring external verification that the property meets green standards at the time of drawdown).

C. Which, if any, standards or certifications can be used to help to determine whether a building is 'green'?

There are a number of standards and certifications which may help in determining the 'greenness' of a particular property. It should be noted that there is, as yet, no industry-wide consensus as to which applicable standards or certifications should be adopted. Some commonly used standards and certifications in the market include:

Company/fund level certifications:

- GRESB ratings
- Alignment to the EU Taxonomy[13] or other recognised taxonomy

Design based certifications:

- Energy Performance Certificates (**EPCs**)[14] (domestic/non-domestic)
- BREEAM New Construction (non-domestic)
- LEED Certification
- HQE Certification (France)
- DGNB Certification (Germany)
- EDGE certification
- Home Quality mark (domestic)
- NABERS Design for Performance (Offices)

Refurbishment & Fit-out

- BREEM Refurbishment & Fit-out
- LEED Certification
- RICS SKA rating
- PAS 2035 (PAS 2035:2019 Specification for the energy retrofit of domestic buildings)
- Passivhaus and EnerPHit Standards
- TrustMark

In-use certification and disclosure:

- BREEAM In-Use ratings
- LEED Certification
- Better Building Partnership Real Estate Environmental Benchmark (not certification but can be used to track performance against an industry benchmark)
- Climate Bonds Certification
- NABERS UK Energy for Offices
- GLA Be-Seen reporting requirements

This list is not an exhaustive list of standards or certifications and there are many other global, national and industry standards that may be used to benchmark the greenness of a building. It should be noted that several of the above certifications/standards are scored or rated (rather than being simply pass or fail) and, accordingly, lenders may require properties to meet certain threshold scores or ratings in order to be considered eligible for financing via a green loan.

D. What data is available to help borrowers and lenders make decisions about the greenness of a particular property?

There are currently data gaps in relation to the energy performance of buildings which can make identification of green properties difficult. Recent efforts have however led to a growth in the availability of data in this area and, where available, this data may be utilised to help financial institutions identify Green Projects in the REF investment context by enabling them to compare one building's environmental credentials against other comparable buildings. Borrowers can also make use of this data to help to identify green properties within their portfolios, where applicable.

11 https://www.lma.eu.com/application/files/7215/8866/8713/GLP_Guidance_V06.pdf

12 https://www.worldgbc.org/what-green-building

13 The EU Taxonomy has not yet been fully implemented but is expected to provide a standard against which borrowers and lenders may seek to align their activities in order to ensure that they are recognised as 'green'. See further Question 2G below.

14 Although EPCs are widely used in the market and can be a useful indicator of the energy efficiency of buildings, it should be noted that there may be drawbacks to relying solely on EPCs because EPC ratings only assess theoretical performance or design intent and do not measure actual energy consumption (https://www.betterbuildingspartnership.co.uk/sites/default/files/media/attachment/BBP%20JLL%20-%20A%20Tale%20of%20Two%20Buildings%202012.pdf).

E. How should borrowers and lenders deal with the situation where only certain properties within a wider portfolio of properties being funded are eligible Green Projects?

Only Green Projects will be eligible for funding via a green loan. Therefore, properties within a broader portfolio of properties which are not eligible Green Projects would not qualify as a green loan. In these circumstances, funds could be advanced by way of green and non-green tranches in order to ensure that funds can be appropriately tracked to their use.

F. Is in-use performance of a building important for determining whether a building is an eligible Green Project?

A green building design will not always translate into better in-use energy performance as much depends on the way in which the building is used (for example, whether lights are left running all day). Accordingly, some financial institutions may also consider the in-use performance of a building when determining whether a property is eligible for funding via a green loan.

Lenders may sometimes ask for an external certification to be provided in relation to the in-use performance of a building, but this will not always be required.

Whether or not leases over the property to be funded are green leases may also be taken into account by lenders when determining the eligibility of a property for green loan funding (for example, by reference to the percentage of green leases vs traditional leases in relation to the building(s)). A green lease is a standard form lease with additional clauses included which provide for the management of, and improvement of, the environmental performance of a building by both owner and occupier(s). Such a document is legally binding, and its provisions remain in place for the duration of the term.[15]

G. What is the EU Taxonomy? How can borrowers and lenders determine whether a property is EU taxonomy aligned?

The EU Regulation on the Establishment of a Framework to Facilitate Sustainable Investment (the **Taxonomy Regulation**)[16] came into force on 12 July 2020. The framework (known as the **EU Taxonomy**) established under the Taxonomy Regulation is a classification tool for sustainable economic activities and is intended to create the world's first-ever 'green list', a common language that investors can use everywhere when investing in projects and economic activities that have a substantial positive impact on the climate and the environment.[17]

The EU Taxonomy sets performance thresholds (**Technical Screening Criteria**) for economic activities which make a substantial contribution to one of the following six EU environmental objectives:

1) climate change mitigation;
2) climate change adaptation;
3) sustainable use and protection of water and marine resources;
4) transition to a circular economy;
5) pollution prevention and control; and
6) protection and restoration of biodiversity and ecosystems.

In addition, the activities must do no significant harm to the other five objectives, where relevant, and meet minimum safeguards (e.g. OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights).

As such, in order for activities in the REF investment context to be considered EU-Taxonomy aligned, they will need to meet the Technical Screening Criteria as well as the other criteria set out above. The Technical Expert Group (**TEG**) on Sustainable Finance's final report on the EU Taxonomy[18] includes an Annex containing the recommended Technical Screening Criteria for different sectors, including construction and real estate activities.[19]

The TEG's recommendations are designed to support the European Commission in the development of delegated acts relating to the environmental objectives under the Taxonomy Regulation. The taxonomy for climate change mitigation and climate change adaptation should be established by the end of 2020 in order to ensure its full application by end of 2021. For the four other objectives, the taxonomy should be established by the end of 2021 for application by the end of 2022.

For further information about the EU Taxonomy, see the LMA webinar '*The EU Taxonomy – what is it and what might it mean for the loan market?*' which is available to view on our website.[20]

15 https://www.betterbuildingspartnership.co.uk/sites/default/files/media/attachment/bbp-gltk-2013_0.pdf

16 https://eur-lex.europa.eu/legal-content/EN/TXT PDF/?uri=CELEX:32020R0852&from=EN

17 https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1112

18 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

19 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy-annexes_en.pdf

20 https://www.lma.eu.com/events/eu-taxonomy-what-it-and-what-might-it-mean-loan-market

3 Project Selection and Evaluation

"The borrower of a green loan should clearly communicate to its lenders:

- its environmental sustainability objectives;
- the process by which the borrower determines how its projects fit within the eligible categories set out in Appendix 1 of the GLP; and
- the related eligibility criteria, including, if applicable, exclusion criteria or any other process applied to identify and manage potentially material environmental risks associated with the proposed projects.

Borrowers are encouraged to position this information within the context of their overarching objectives, strategy, policy and/or processes relating to environmental sustainability. Borrowers are also encouraged to disclose any green standards or certifications to which they are seeking to conform."

– Extract from the GLP

A. How might the borrower under a green REF investment loan seek to communicate the above information to its lenders?

As mentioned above, borrowers may wish to produce a green finance framework setting out, amongst other things, the above information. A full green finance framework may not be appropriate for all green REF investment transactions and so borrowers and lenders should agree on a case-by-case basis how this information will be communicated.

4 Management of Proceeds

"The proceeds of a green loan should be credited to a dedicated account or otherwise tracked by the borrower in an appropriate manner, so as to maintain transparency and promote the integrity of the product. Where a green loan takes the form of one or more tranches of a loan facility, each green tranche must be clearly designated, with proceeds of the green tranche(s) credited to a separate account or tracked by the borrower in an appropriate manner.

Borrowers are encouraged to establish an internal governance process through which they can track the allocation of funds towards Green Projects."

– Extract from the GLP

A. How can borrowers and lenders best achieve management of proceeds in relation to a green REF investment loan?

The proceeds of a REF investment loan will often be paid into a designated account so that these funds can clearly be identified. Alternatively, borrowers may provide information to lenders to enable them to track the use of the proceeds of the green loan towards an eligible Green Project.

Undertakings and representations relating to the use of proceeds for eligible green projects are often included in the relevant facility agreement in order to ensure that the borrower uses the loan proceeds for the intended purpose.

Other means of managing the end use of proceeds may include:

- a requirement for a funds flow statement to be provided as a condition precedent to drawdown (together with an undertaking to apply the funds in accordance with this funds flow statement);
- a requirement to supply invoices and other evidence confirming use of proceeds as conditions precedent to each utilisation;
- provision of any other relevant conditions precedent prior to each utilisation; and/or
- third party verification of the use of proceeds.

5 Reporting

"Borrowers should make and keep readily available up to date information on the use of proceeds to be renewed annually until fully drawn, and as necessary thereafter in the event of material developments. This should include a list of the Green Projects to which the green loan proceeds have been allocated and a brief description of the projects and the amounts allocated and their expected impact. Where confidentiality agreements, competitive considerations, or a large number of underlying projects limit the amount of detail that can be made available, the GLP recommend that information is presented in generic terms or on an aggregated project portfolio basis. Information need only be provided to those institutions participating in the loan.

Transparency is of particular value in communicating the expected impact of projects. The GLP recommend the use of qualitative performance indicators and, where feasible, quantitative performance measures (for example, energy capacity, electricity generation, greenhouse gas emissions reduced/avoided, etc.) and disclosure of the key underlying methodology and/or assumptions used in the quantitative determination. Borrowers with the ability to monitor achieved impacts are encouraged to include those in regular reports"

– Extract from the GLP

A. What type of reporting obligations are typically expected from borrowers under a REF investment loan facility?

Again, there is no one size fits all approach here and reporting obligations will depend on the size and nature of the transaction and the borrower. In line with the GLP, best practice is for borrowers to report at least annually on the use of proceeds to be renewed annually until the loan is fully drawn, and as necessary thereafter in the event of material developments. This form of reporting may assist lenders with tracking use of green loan proceeds. Borrowers will also often report on the impact of the green funding on their property portfolio.

The borrower may also be required to report to lenders at set intervals on the in-use performance of the building (for example, energy or water consumption) where this is part of the eligibility criteria for the green loan.

The borrower and lender should clearly agree and document any reporting obligations in the REF investment facility agreement. Where the borrower has produced a green finance framework, it may also wish to include details of its reporting commitments in this document.

6 Review

"When appropriate, an external review is recommended. There are a variety of ways for borrowers to obtain outside input into the formulation of their green loan process and there are several levels and types of review that can be provided to those institutions participating in the loan."

– Extract from the GLP

A. What types of review might take place in relation to a REF investment loan facility?

The GLP provide further details of the different types of review which may be carried out in relation to a green loan. Borrowers and lenders should discuss and agree whether any of these types of review or audit are appropriate for the relevant green REF investment loan and document any related conditions precedent (for example, second party opinions or evidence that certifications/standards have been achieved). If so, the nature and frequency of such review or audit will also need to be agreed upon.

Where a green finance framework is provided by the borrower, best practice is to ensure that this is externally verified by an appropriately qualified third-party verifier.

7 Other

A. What will constitute a "green breach" under a green loan in the REF context?

Whilst there is currently no established market standard in relation to what will constitute a "green" breach in the REF context, this should be clearly documented in the facility agreement in respect of each deal.

The use of proceeds is a key determinant of a green loan. Consequently, any breach of the use of proceeds provisions should be taken seriously and the loan should not be considered green from the date of occurrence of such event, subject to any cure rights. Parties should give due consideration as to whether or not a failure to apply the proceeds of a green loan towards a Green Project will trigger an event of default, and a subsequent cross-default across outstanding loans.