Helaba

Focus on: Sustainable Finance
09. November 2022

The rendez-vous clause: An effective interim step towards an ESG-linked margin ratchet

Rainer Neidnig
Head of Sustainable Finance Advisory
Tel. +49 69/91 32-3862

Sustainability-linked loans, in which the borrower's credit margin is tied to sustainability indicators, are becoming a standard feature of syndicated credit facilities. The basic premise is simple: linking the cost of borrowing to sustainability KPIs provides an additional incentive to achieve pre-defined sustainability targets. But what if the customer is not yet able to report sufficiently reliable ESG data or is still in the process of developing its strategic sustainability goals? For cases such as these, a concept known as *rendez-vous clause* has evolved that enables specific KPIs and their associated performance metrics to be defined after the facility agreement has been signed. Implemented correctly, the rendez-vous clause offers a number of advantages for all parties to the facility agreement. Ultimately, the significance of the selected metrics and the level of ambition of the pre-determined targets are critical to the quality of an ESG-linked margin ratchet.

Incentivising sustainable practices the core idea

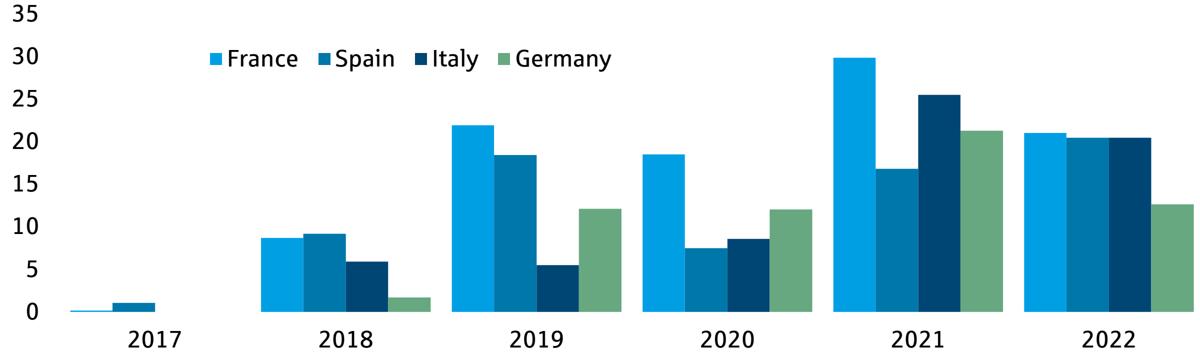
The Loan Market Association's (LMA) Sustainability-Linked Loan Principles provide a clearly defined framework for the key components of a sustainability-linked loan. In essence, the goal for all parties is to agree on ambitious targets for strategically relevant sustainability metrics. The achievement or failure to achieve these targets then determines whether the borrowing costs are adjusted or not. In the current interest environment, this ESG margin adjustment is typically between 2.5 and 5 basis points, depending on the borrower's credit quality. This is considerably less than margin adjustments based on credit ratings or financial ratios, but in our experience, it is more than adequate in giving a boost to the importance of a company's sustainability management. However, a sustainability-linked loan structured in line with LMA standards is conditional on the borrower already having in place (i) a robust sustainability reporting system with relevant KPIs, (ii) a sustainability strategy with clearly identifiable priorities, and (iii) quantified sustainability targets.

Preparedness varies between companies and countries

Major publicly listed companies almost always meet these criteria, as many institutional investors have had ESG on their radar for many years already. However, unlisted companies or midcaps frequently lack the necessary prerequisites - at least in Germany. This is because many German *Mittelstand* companies are not yet subject to mandatory sustainability reporting, which will not be required until the Corporate Sustainability Reporting Directive (CSRD) comes into widespread force from the 2024 or even 2025 reporting year. That will also see the introduction of specific requirements on the nature and scope of metrics companies will have to report on as well as of mandatory third-party verification. Other countries are already further ahead in this respect, with France leading the way. Germany's western neighbour imposed compulsory ESG reporting requirements on companies with annual sales of more than EUR 100 million and more than 500 employees as early as 2011. It comes as little surprise, then, that French companies were among the first to adopt the new concept of sustainability-linked loans, whereas many companies in Germany are still developing their sustainability strategies or sustainability reporting systems. Hence, at Helaba's Sustainable Finance Advisory unit we are often approached with the question as to whether or how corporate borrowers could implement an effective ESG-linked margin ratchet. For our clients, this issue is all the more pertinent given that syndicated facilities are frequently structured with a five-year maturity and two one-year extension options (5+1+1) – a total term of seven years when factoring in the extension period. Consequently, there are few opportunities for adding an ESG component to a syndicated credit facility.

French companies as pioneers in the adoption of sustainability-linked loans

Volume in USD (millions)



Sources: Bloomberg, Helaba Research & Advisory

Rendez-vous clause an interim step ...

The rendez-vous clause offers a practical solution for situations such as those described above, in which implementing an ESG-linked margin ratchet is not immediately feasible, and its application has been on the rise for several months now. Despite the absence of a common market standard to date, a clear pattern for its use has already emerged: the approach at the heart of the rendez-vous clause is to establish the technical provisions for an ESG margin ratchet at the time the contract is concluded and determine the precise ESG-related KPIs and targets at a later date in the scope of a *Sustainability Supplement*. At the same time, in the rendez-vous clause the borrower declares its intention to agree with the lenders within a specified period of time on the required KPIs and targets as well as how they will be linked to the borrowing costs. Although failure to meet this deadline rarely results in any specific consequences, such as an increase in the margin, it incentivises borrowers to adhere to a strict timetable for fear of reputational damage vis-à-vis their banks.

Snapshot: Sustainability-linked loan vs. loan with rendez-vous clause

	Sustainability-linked loan	Loan with rendez-vous clause
Specific definition of ESG-related KPIs	✓	× Only name of KPIs
Number of ESG-related KPIs	✓	✓
Definition of ESG targets	✓	×
Level of ESG margin adjustment	✓	✓
Mechanism for ESG margin adjustment	✓	×
Reporting requirements	✓	✓
Type and scope of KPI verification by third party	✓	✓
Special provisions (M&A, force majeure, etc.)	✓	✓
Deadline for Sustainability Supplement	n.a.	✓

... with advantages for all parties involved

A rendez-vous clause has obvious advantages for borrowers. It buys them time to identify the most appropriate metrics and to compile them as reliable datasets, to develop strategic benchmarks or to distil existing long-term goals into specific annual milestones. For many borrowers, this is the only way to develop an ESG-linked margin ratchet that effectively incentivises their organisation to adopt a more sustainable approach to their business activities. In this sense, lenders who recognise the importance of a robust ESG concept rather than simply accepting any kind of ESG-linked margin ratchet that "ticks the box" will also benefit from a rendez-vous solution.

Moreover, experience has clearly shown that, far from acting as a brake, a rendez-vous clause in fact has the effect of accelerating the development of sustainability reporting systems and sustainability strategies. In particular, once a contractual relationship has been established between sustainability issues and financing arrangements, it greatly enhances the role that sustainability teams play within a company and its attention by senior management. This is a crucial point, as it is usually necessary to involve a large number of departments on the operational side of a business in order to collect sustainability-related, non-financial performance indicators or to determine specific ESG targets. The additional time and effort that this often entails could become a stumbling block. The support of the sustainability team by senior management acts as a catalyst in situations like these.

For banks, too, the timely roll-out of sustainability reporting systems and the definition of specific ESG targets are a welcome step given that the importance of non-financial, sustainability-related data in the credit risk process is on the rise. What is more, the rendez-vous clause has a positive side effect that is not directly related to its original rationale: the decision by a bank on whether to participate in a syndicated facility is no longer contingent on its approval of the proposed ESG-linked margin ratchet. This is because, in practice, not all loans with the "sustainability-linked" designation actually merit this label as there are enormous variations in the relevance of associated KPIs and, above all, in the level of ambition of the respective targets. This poses a dilemma for financial institutions because, in many cases, being one of a company's core banks, and therefore benefiting from lucrative sideline business, depends on its participation in the client's core syndicated credit facility. Consequently, there is considerable commercial pressure on banks to take part in such a transaction. To avoid any "greenwashing", then, in principle it would make sense to separate the decision on whether to participate in a loan from that on the ESG-linked margin ratchet - and that is precisely what the rendez-vous clause does.

No uniform market standard yet, …

Alongside the common patterns described above, in practice there are a variety of ways in which specific aspects of contracts differ from one another. For instance, in some cases the rendez-vous clause only refers to one of three KPIs, while the other two, including their associated targets, are already explicitly defined at closing of the transaction. In other cases, the annual targets have already been determined up to a certain reporting year but have yet to be defined for subsequent years. Moreover, some borrowers have chosen to narrow down the areas of action by naming specific ESG issues, such as a reduction in greenhouse gas emissions or a higher level of diversity in management positions. That only leaves the precise definition of the corresponding indicator(s) and targets that have yet to be established. Another key factor is the timeframe: While earlier rendez-vous clauses did not include a deadline for agreeing a Sustainability Supplement, this has now become standard practice. There is also no common standard for the level of consent required from lenders for the Sustainability Supplement, and this is unlikely to change in future (see below). Finally, should the parties fail to conclude a Sustainability Supplement before the contractually agreed deadline, it is possible to apply a penalty in the form of a higher margin - although this has not yet become a widespread practice in the market.

… but best practices are emerging

Whenever a credit facility includes sustainability aspects, *clarity* and *transparency* are key to its success. In accordance with LMA standards, a sustainability-linked loan agreement must define the relevant KPIs and target metrics for the ESG-linked margin ratchet before or at closing. It follows, then, that the term "sustainability-linked loan" should be avoided altogether for loans that contain a rendez-vous clause. Likewise, alternative terms such as 'ESG-linked' or 'sustainability-related' should not be applied until the Sustainability Supplement has been signed and sealed. However, we believe that disclosing the specific KPIs and the level of the target metrics to a broader audience is even more important, regardless of whether they were determined at the time of or subsequent to closing the contract. Such an approach is not only recommended by the LMA, but in our view also constitutes the best form of protection against any potential misleading claims and greenwashing.

In terms of the *timeframe* of an agreement, we consider it essential that a deadline be defined for agreeing on a Sustainability Supplement. Obviously, it is always important to consider the specific circumstances in any particular company, especially with regard to the current status of sustainability reporting and the available resources in the sustainability team. Nevertheless, "the earlier the better" is a good rule of thumb here.

A more difficult question to answer is whether there should be *majority or unanimous consent* among banks in the syndicate on approving the Sustainability Supplement. What is evident, however, is that as many banks as possible should endorse the selected KPIs and target metrics from a sustainability perspective. It is also clear that the majority consent route is conditional on the potential level of the ESG-linked margin ratchet being determined in advance. The question as to which approach is more appropriate, though, depends on the specific circumstances of that particular case. In a club deal with a small number of banks, the consent of all lenders would no doubt be preferable. For larger syndicates, this solution could run the risk, from a borrower's point of view, of a single bank exploiting its consent to a robust Sustainability Supplement as a bargaining chip for other purposes. The prospect of a single bank blocking an ESG-linked margin ratchet, which all other banks in the syndicate would like to adopt, would also prove detrimental from the other banks' standpoint. Furthermore, unlike unanimous approval, majority consent allows for feedback that is free from commercial considerations, as a single bank would not have to fear being cast as the "spoilsport". At the end of the day, majority consent does not necessarily mean that criticism goes unheeded or that a proposed ESG concept cannot be modified. After all, responsible companies and banks have well-intended goals in implementing ESG-linked margin ratchets and are therefore prepared to invest a considerable amount of additional time and effort in order to achieve the best possible outcome.

Sign up for our newsletter here:

https://news.helaba.de/research/

Publisher and editor

Author: Rainer Neidnig
Helaba Research & Advisory

Editor: Stefan Rausch

Publisher:
Dr. Gertrud R. Traud
Chief Economist/
Head of Research & Advisory
Neue Mainzer Str. 52-58
60311 Frankfurt am Main
Tel. +49 69/91 32-20 24
Internet: http://www.helaba.de

Disclaimer

This publication was very carefully researched and prepared. However, it contains analyses and forecasts regarding current and future market conditions that are for informational purposes only. The data are based on sources that we consider reliable, though we cannot assume any responsibility for the sources being accurate, complete, and up to date. All statements in this publication are for informational purposes. They must not be taken as an offer or recommendation for investment decisions.