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Lending Goes Green – What Non-Energy-Sector Borrowers Can Expect in the Future

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News reports are filled with stories about the world's efforts to manage greenhouse gases and climate change. Several lenders have taken a lead in these efforts by considering energy-sector borrowers' greenhouse gas emissions when making loans. This practice is not surprising in light of the energy sector's substantial contribution to greenhouse gas emissions. However, the current mortgage and financial crisis, as well as a number of other factors, will likely pressure or force lenders to make increasingly conservative lending decisions related to carbon emissions and climate change risks. This article will explore some current lending practices imposed upon utility-sector borrowers that may spill over into other business loans, and the reasons why lenders may evaluate climate change risks more closely in the future.

In February of 2008, Citi, JPMorgan Chase, and Morgan Stanley announced the "Carbon Principles," a guideline for evaluating and managing the risk of financing electric power projects in the United States. The institutions advanced the Carbon Principles "to create an industry best practice for the evaluation

of options to meet the electric power needs of the US in an environmentally responsible and cost-effective manner." As part of the Carbon Principles, these banks developed the "Enhanced Environmental Diligence Process" to assess projects based on the following factors:

- *Energy efficiency* – The banks will encourage clients to invest in cost-effective demand reduction and support regulatory and legislative changes that increase efficiency in electricity consumption.
- *Renewable and low carbon energy technologies* – The banks will encourage clients to invest in cost-effective renewables, fuel cells, and other low carbon technologies, as well as support legislative and regulatory changes that promote and remove barriers to such investments.
- *Conventional or advanced generation* – The banks recognize the need for continued

development and financing of conventional energy generation, but acknowledge that “due to evolving climate policy, investing in CO₂-emitting fossil fuel generation entails uncertain financial, regulatory and environmental liability risks.”

A bank’s assessment in accordance with this Enhanced Environmental Diligence Process is intended to help evaluate whether and under what terms a transaction is eligible for financing. Of course, some groups have expressed concern that the Carbon Principles are merely a statement of intent without binding commitments. Others fear that any attempt to put a standardized system into place will result in irrational financing and investment decisions. Nevertheless, the fact that the Carbon Principles were advanced is a profound indicator that carbon emissions and climate change are now on lenders’ minds when it comes to evaluating potential loans.

Also in February, 2008, the *Wall Street Journal* reported that Bank of America would begin factoring the cost of carbon into its risk and underwriting processes when evaluating the business models of utility-sector companies. According to the *Charlotte Observer*, that same month, the bank went so far as putting a value on carbon emissions at somewhere between \$20-\$40 per ton of carbon dioxide. Almost a year earlier, in its 2006 Sustainability Report, Bank of America had declared that it would change the mix of its loan portfolio to reduce its overall greenhouse gas emissions by 7%, and that it would invest \$20 billion over 10 years to develop and encourage new climate-friendly technologies.

Other banks are also taking public steps to influence and evaluate their borrowers’ carbon emissions. HSBC is reportedly the world’s first carbon neutral bank and has invested \$90 million to improve the energy efficiency of its own buildings while launching a stock market index to track companies that are poised to profit from the challenges associated with climate change. Wells Fargo announced in November, 2008, that it has exceeded \$2 billion in funding for LEEDS-certified buildings. The *Financial Times* reports that the Royal Bank of Scotland is the world’s largest arranger of financing for renewable energy; *Investment News* adds that it has already invested \$2.6 billion in the market and intends to invest an additional \$30 billion in alternative technology and clean energy over the next 10 years. It also reports that Morgan Stanley has invested \$300 million in clean energy and an additional \$2.7 billion in carbon credits. These banks provide just a few examples of the growing trend in the banking industry as a whole to encourage renewable and clean energy borrowers.

Lenders may begin taking other prospective borrowers’ carbon emissions and climate risks into account for several reasons. Banks and other businesses increasingly see marketing benefits from the public perceiving their business as “green,” and there is a growing public perception that banking institutions ought to take heightened responsibility for advancing reductions in carbon emissions because of their great sphere of influence over economic development. Officers and directors of lending institutions may also have duties (enforceable by shareholders or government regulators) to evaluate how climate change risks may impact their business and take steps to

minimize these risks. The Intergovernmental Panel on Climate Change predicts increased frequency of heat waves over most land areas, more frequent heavy precipitation events, greater areas affected by droughts, intense tropical cyclone activity increases, and increased incidences of extreme high sea levels. Consequently, there may be increased risk that many businesses, including agriculture, tourism, operations near shorelines, businesses dependent on large volumes of water, and others, may be directly and adversely impacted by increased global temperatures.

Lenders and their borrower clients might also be forced into costly litigation, particularly if the federal government continues to fail to impose regulation on greenhouse gas emissions. In *Massachusetts v. Environmental Protection Agency*, 549 U.S. 497 (2007), the Supreme Court found that the Clean Air Act's definition of "air pollutant" encompasses greenhouse gases, including carbon dioxide, and, therefore, the Environmental Protection Agency ("EPA") has authority to regulate greenhouse gas emissions under the Act. The case may ultimately have far-reaching effects not only on the regulation of emissions from motor vehicles, but also on other Clean Air Act programs, including regulation of fuels, new or modified stationary sources (potentially including large office buildings), aircraft, and ocean-going vessels. After the Supreme Court decision was issued, the EPA initially announced that it would respond by the end of 2007, but in July of 2008, it announced that it would further extend the public comment period, effectively delaying any regulation until after the

November elections. *Reuters* quoted Agency Administrator, Stephen Johnson, as arguing that the EPA is the wrong agency to impose broad regulation of greenhouse gases and that it is the responsibility of Congress to develop legislation that will "cut through what is likely to be decades of regulation and litigation." In July, 2008, twelve litigants, including the California Attorney General, state agencies and non-governmental groups, sent notice to the EPA that they intend to bring suit against it to force a decision if one is not made within 180 days, citing "unreasonable and unjustifiable delays." The 180 days will run out in January of 2009.

Meanwhile, Congress has been actively working on developing greenhouse gas legislation, most of which favors a "cap and trade" program that affects both energy and non-energy-sector carbon emitters. On December 5, 2007, the Lieberman-Warner Climate Security Act was approved by the Senate Environment and Public Works Committee. Unlike other carbon legislation, this was the first, and so far the only, bill to make it through a congressional committee. Although the bill was never passed, it would have generally limited the carbon emissions of electric power, transportation and manufacturing sources that emit more than 10,000 carbon dioxide equivalents of greenhouse gas per year, which, according to the USA Climate Network and other proponents of the bill, encompasses 75% of the United States' carbon emissions. Other proposed bills, such as the Safe Climate Act proposed by Representative Waxman and the Global Warming Pollution Reduction Act proposed by Senators Sanders and Boxer, would have required reduced emissions from all carbon

sources, not just the major sources targeted by the Lieberman-Warner Bill.

Under the Lieberman-Warner Bill, affected companies would be allowed to trade, save, and borrow emission allowances and generate credits when they induce other non-covered businesses to reduce their carbon emissions. Thus, even if a business were not directly affected by the bill, it could face pressure to reduce its emissions from other directly regulated businesses to which it sells products or provides services. Consequently, it is easy to imagine routine lender questions to potential borrowers in all industries related to the borrower's level of carbon emission, its relationships to major carbon emitters, its classification by the EPA, and its balance of carbon credits.

Commentators are even more certain that carbon regulation will be passed in the near future now that Barack Obama has won the presidential election. Additionally, House Representative Henry Waxman very recently won the chairmanship of the House Energy and Commerce Committee, replacing Representative John Dingell. Dingell had introduced a carbon regulation bill in November, 2008. It set ambitious long-term goals, but was criticized by environmental groups for not setting more restrictive standards in the short term. Representative Waxman, on the other hand, is recognized as taking a more aggressive approach to climate change. It is expected that the Dingell bill will be bypassed for a new, more restrictive and more ambitious climate change bill to be addressed under the new Obama Administration.

Lenders are likely to continue to take steps to reduce risks of carbon emissions by limiting investments in non-renewable energy sources, avoiding links to major carbon-producing borrowers, instituting an overall reduction in their entire portfolio's carbon footprint, and requiring additional compensation or security for loans to borrowers that emit greenhouse gases or are otherwise exposed to climate risk. So far, the trend to consider carbon emissions has been limited to the evaluation of loans to utility-sector borrowers, but, as explained above, many non-utility borrowers may be similarly exposed to carbon emission and climate risks. It will only be a matter of time before an evaluation of these risks will directly impact loan financing and underwriting decisions.

Those who represent both utility and non-utility borrowers may consider the following suggestions. First, recommend to clients that they consider incorporating energy efficiency and other "green" concepts into their core business strategy now in order to make themselves more attractive to lenders in the future. Second, discuss quantifying the client's current carbon emissions in anticipation of a lender requesting that information in the future. This information may be complicated and lengthy to compile and could potentially slow down a financing transaction if not properly anticipated. Finally, be alert for loan document provisions such as covenants, representations and warranties addressing carbon emissions and energy efficiency practices. Object to their inclusion initially, but be aware that these provisions could eventually become industry standard.