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Challenges to Mainstreaming ESG in Financial Markets

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The present and future impacts of climate change, human rights violations, environmental, labor and regulatory violations and poor corporate governance on the quality of investments and credit risks have spurred widespread recognition of the importance of environmental, social and governance (ESG) considerations in lending and investment activities.

As the value ascribed to robust ESG credentials continues to grow, companies and financial institutions are increasingly seeking ways to conduct business in an environmentally conscious manner and to minimize ESG risks.

“Sustainable finance” is the phrase that describes the suite of innovative financial products that have arrived in debt and capital markets over recent years. These products facilitate and support the financing of green, sustainable and ethical projects, as well as sustainable businesses.

Financial market participants now possess a range of tools to encourage, reward or punish borrowers and issuers engaged in developing green projects (such as renewable power generation, carbon reduction, waste reduction and energy efficiency projects) or the implementation of sustainable business strategies designed to achieve concrete and verifiable ESG goals.

Global Initiatives

A multitude of sustainable finance and development initiatives have been implemented internationally and nationally, highlighting the growing urgency for ESG integration into financing arrangements and corporate behavior.

The U.N. Global Compact, a nonbinding U.N. initiative created in 2000, encourages businesses worldwide to adopt ESG policies and procedures aligned with the so-called “Ten Principles” in areas of human rights, labor, environment and anti-corruption. This Compact currently has over 9,500 corporate participants based in more than 160 countries.

The U.N. 2030 Agenda for Sustainable Development was adopted in 2015 by all 193 Member States of the U.N, including the United States. It provides a comprehensive roadmap for states to achieve ambitious sustainable development goals by 2030.

At the European Union level, the European Commission Action Plan for Financing Sustainable Growth highlights the need to reorient private capital toward sustainable investments alongside the positive implications of incorporating ESG into investment decisions.

The Principles for Responsible Banking, launched during the annual U.N. General Assembly last year, is one of the most recent initiatives aimed at accelerating the banking industry’s progress toward achieving its sustainable development goals and the Paris Climate Agreement (with the 132 founding signatory banks representing over $47 trillion in 49 countries).

In the financial markets, the Equator Principles have been used since their launch in 2003 as an industry benchmark for identifying and managing environmental and social risks in project finance transactions. It presently has 101 financial institution signatories from 38 countries.

Similarly, the International Finance Corporation, a member of the World Bank Group, has created a “Sustainability Framework” to promulgate international standards relating to ESG and sustainability, and the Inter-American Development Bank has spearheaded the effort to require its borrowers to comply with clear and verifiable ESG requirements in Latin America.

These are just a few examples of the multitude of global initiatives in place to expand the use of ESG in different industries and economic sectors. A recent addition to this list is Blackrock’s decision to heighten its scrutiny of ESG factors in its investments and its decision, among other things, to divest from the coal-burning energy sector.

One manifestation of these initiatives is the green bond market, which has grown exponentially since its inception over a decade ago. A green bond is a bond in which the proceeds are specifically earmarked for environmentally friendly projects. While the vast majority of green bonds are issued outside of the Americas, this trend is quickly reversing. While there is strong interest from investors for this type of investment, there may not yet be a significant pricing difference for green bonds.

The loan markets' response is the joint recognition by the Loan Market Association, Loan Syndications and Trading Association and Asia Pacific Loan Market Association of two of the newest sustainable finance products in the market: green loans and sustainability linked (SL) loans. In addition, the Loan Syndications and Trading Association has been actively working on standardizing ESG due diligence processes by lenders.

Green Loans and SL Loans

It is important to note that although green loans and SL loans are both aimed at facilitating and supporting environmentally sustainable activity, they are distinctive financial products.

The defining characteristic of a green loan is the specific use of loan proceeds, which, like for green bonds, must be dedicated exclusively for green projects. Eligible projects are set out in a nonexhaustive list included in the Green Loan Principles, a set of voluntary, high-level guidelines published by the loan associations and modelled on existing Green Bond Principles.

In contrast to green bonds and loans, SL loans, also known as positive incentive loans, apply to "any type of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit)"and permit proceeds to be applied for a company's general purposes. Their defining feature is that the borrower's compliance with pre-agreed sustainability performance targets (compatible with a borrower's disclosed Corporate Social Responsibility strategy) has a partial impact on the pricing of the loan. Thus, for instance, a borrower may see an increase or reduction on the margin depending on the amount of energy it sources from renewables, the degree by which it improves its ESG rating (typically provided by a specialist rating agency) or its ability to meet such targets over the duration of the loan. Targets must be ambitious but realistic, based on a borrower's verifiable sustainability record.

As SL loans are linked to a company's overall ESG profile rather than requiring a specific use of proceeds, they offer greater flexibility and have made the sustainable finance market accessible to a broader spectrum of companies that would not be able to obtain financing through (and take credit for the use of) green bonds or loans. SL loans are supported by published guidelines (the Sustainability Linked Loan Principles).

By way of illustration, agricultural commodities companies such as COFCO International and Louis Dreyfus have executed SL loans (for $2.1 billion and $750 million, respectively) in which the facilities' margins are linked to sustainability targets such as improvement in the traceability of agri-commodities and improved waste and water management. COFCO International also said that it planned to reinvest any savings achieved into further improving its ESG performance. Nokia has entered into a 1.5 billion euro facility which offers a lower cost of borrowing for greenhouse gas emissions reductions, and Danone has a 2 billion euro SL loan in which pricing is linked to Danone's ESG rating.

A company does not have to operate in a strictly green industry to obtain a green loan or SL loan, and it may seem paradoxical to some that "brown industries" such as oil and gas and mining, whose activities increase pollution and other detrimental impacts in the environment, are not excluded. However, there is a strong business case for bringing these companies into the sustainable finance fold, not least to supplement recent efforts by the fossil fuel industry as a whole to operate more sustainably.

For example, some oil majors are members of the Oil and Gas Climate Initiative, a CEO-led initiative to reduce greenhouse gas emissions. The International Petroleum Industry Environmental Conservation Association, which is tasked with advancing environmental and social performance, published guidance in 2015 on voluntary sustainability reporting for oil companies to benchmark their individual sustainability performance and further guidance in 2017 on mapping the oil and gas industry to the U.N.'s sustainable development goals. This is not to say that just any fossil fuel company will be able to take out a green loan or SL loan; lenders will usually require that borrowers demonstrate a minimum commitment to sustainability in accordance with the Green Loan Principles and Sustainability Linked Loan Principles, usually evidenced through robust internal and publicly disclosed policies and realistic, verifiable performance targets.

Standardizing Lenders' ESG Diligence

On Jan. 10, the Loan Syndications and Trade Association circulated a draft ESG Diligence Checklist to be used by lenders to obtain information from borrowers on ESG matters as part of the loan origination process. The questionnaire is available at the association's website and, following review of public comments, was published in final form Feb. 3.

Challenges to Mainstreaming ESG in Financial Markets

Despite the steps taken to enhance the integrity of the sustainable finance market through the implementation of guidelines and market standards, hurdles remain to the widespread uptake of sustainable finance products.

First, a lack of consistency among global ESG initiatives means there is ambiguity around what exactly constitutes a sustainable project. The current patchwork of sustainability classification standards has given rise to concerns about "greenwashing," whereby a company misleadingly markets itself as being environmentally conscious purely to boost its green credentials without demonstrably adhering to any concrete and verifiable goals. Securing financing on this basis has the potential to undermine the entire premise of the sustainable finance market.

Second, there appears to be insufficient consistency in the quality and comparability of ESG rating methodologies, though we see substantial progress in this area, including efforts to bring out a large amount of transparent and verifiable information by credit rating agencies, specialized firms and market participants.

Finally, sustainability reporting by companies remains somewhat inconsistent and often contains information gaps, making it difficult for lenders and investors to fully assess a company's ESG profile or sustainability record. Situations may arise in which a borrower may inaccurately report certain metrics (or stop reporting altogether), and the parties will need to agree upon the economic consequences of such behavior in the loan facility.

The steady advances on standardization, comparability and uniformity of information in the sustainable finance market should promote its integrity and ensure its expansion. Best practices are being developed as the sustainable finance market evolves, and it is likely that performance targets will become more ambitious over time.

Conclusion

Green and SL loans are part of a fundamental paradigm shift taking place in the financial industry. ESG considerations are moving from the periphery to center stage as core requirements that must be factored into financing arrangements and at all stages of the investment cycle. Green Loan and Sustainability Linked Loan principles provide valuable guidance for users of green and SL loans by standardizing the swathe of new terminology in the market, and strengthens oversight by requiring companies to comply with comprehensive reporting and record-keeping obligations.

An EU "taxonomy," currently in progress and aimed at providing technical screening criteria and methodologies for evaluating green activities, could serve as a roadmap for implementation in the United States, where the sustainable finance market is comparatively new.

Financial institutions have more tools at their disposal to effect change by driving environmentally conscious behavior across industries, while also meeting board and investor demands for increased volumes of sustainability-driven lending. Borrowers can benefit directly from improved pricing on their loans and indirectly by signaling to their investors their focus on operating sustainably. The net effect of this paradigm shift will result in new sources of capital for environmentally beneficial projects and activities.

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