CLIFFORD CHANCE

ESG INITIATIVES – FROM POLITICS TO THE LENDING MARKET

– THOUGHT LEADERSHIP

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Environmental, Social and Governance ("*ESG*") initiatives are at the forefront of today's market economy as government and corporate leaders are urging advancements in sustainable investing. These broad-sounding terms have specific implications for the economy and corporate world, influencing the public and private sector, corporate behavior, new regulations, disclosure mandates and the lending market. In our series of articles covering the evolving ESG landscape we explore the changing discourse of leadership (both political and corporate), how such discourse presents opportunities in finance, and how legislative action may force the hand of holdouts in industry, all with a view of producing tangible milestones to measure progress of ESG initiatives.

Key issues

- ESG initiatives are prioritized by the Biden administration
- ESG investments are at the forefront of corporate initiatives
- ESG-related loans are sweeping the lending market

POLITICAL AND CORPORATE BEHAVIOR

A New National Mandate

During then-candidate Biden's presidential campaign, Biden pledged that sustainable investing and climate policy would be at the forefront of his political agenda. Now as President, Biden has already acted on his green promises and has urged the country to achieve a net-zero economy by 2050. As of the date of writing, President Biden has signed 32 executive orders, with several focused on ESG initiatives.[1] During his first month in office, in a sweeping set of climate-related executive orders, President Biden brought the US back into the Paris Agreement on climate change, directed the Department of the Interior to pause new oil and gas leases on federal lands, urged plans to eliminate fossil fuel subsidies and called for the government's vast fleet of cars and trucks to switch to electric vehicles.

The actions of the Biden administrative extend beyond changes in government to influence the behavior of private citizens and corporate leaders. Currently, per Securities and Exchange Commission ("*SEC*") regulations, public companies are only required to disclose ESG information if that information is deemed material to investors and the issuer's business. However, with Biden's appointment of Gary Gensler as Chairman of the SEC, some experts predict that the SEC may soon require public companies to disclose climate-related financial risks and greenhouse gas emission data in their operations and supply chains.

First Movers in Industry

As the government rolls out climate and ESG-related regulation, certain major players in the corporate sector are already moving forward with their own ESG initiatives as well. BlackRock CEO, Laurence D. Fink, emphasized the importance of sustainable investments in his annual market-moving letter to the world's CEOs and in his annual letter to BlackRock shareholders. Mr. Fink specifically called on companies to begin disclosing plans for how their business models will be compatible with a net-zero economy, urging companies to move quickly on this front rather than waiting for regulators to impose requirements on them. Mr. Fink's letter highlights two important movements in the sphere of ESG initiatives today. First, that companies are taking sustainability initiatives seriously and many are not waiting for regulatory guidance to lead the way. As more companies are beginning to consider how their business models reflect ESG targets, there is now more

1. FACT SHEET: President Biden Takes Executive Actions to Tackle the Climate Crisis at Home and Abroad, Create Jobs, and Restore Scientific Integrity Across Federal Government, The White House Briefing Room, (Jan. 27, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/01/27/fact-sheet-president-biden-takes-executive-actions-to-tackle-the-climate-crisis-at-home-and-abroad-create-jobs-and-restore-scientific-integrity-across-federal-government/

pressure in the market for other companies to do the same. Second, and perhaps even more important, investors are beginning to respond positively to such calls for action. During 2020, 81% of a globally-representative selection of sustainable indexes outperformed their parent benchmarks.[2] ESG-focused companies were able to produce high yields during the global pandemic and the resulting economic downturn, impressing many investors. These results are significant, proving that ESG initiatives are not only principled investments, but financially profitable investments as well.

The early executive actions of President Biden highlight the current administration's commitment to ESG initiatives. While it remains to be seen how this commitment will ultimately manifest in legislative and regulatory mandates affecting public and private companies, the executive branch is forging ahead to promote ESG principles, influencing the behavior of the corporate sector, which is itself leading the way forward in a sustainable investing market.

THE LENDING MARKET

With government and corporate leadership's notable embrace of ESG principles, the lending world has welcomed an influx of Green Loans and Sustainability Linked Loans ("*SLLs*") – in fact, the volume of sustainable lending activity has grown globally by fifteen times in just the last four years.[3] Green Loans are loans with a dedicated use of proceeds designated for a green purpose or project with clear environmental benefits. SLLs, on the other hand, seek to support and improve the company's sustainability profile, often through a margin adjustment incentive linked to the borrower's achieving certain negotiated sustainability targets, but without a designated green use of proceeds. SLLs are typically a more popular option among borrowers given this flexibility.

The New Diligence Paradigm

The global sustainable lending market reached $199.4 billion in 2020, with the fourth quarter alone achieving $75.3 billion and with European borrowers accounting for 64% of the market volume.[4] As borrowers and lenders become increasingly interested in ESG products, the loan market has begun working and adjusting to create standards for evaluating the sustainability linked principles on which such loans are based. Without such clear or objective standards, there is some risk of "green washing" in the market, where the standards on which the Green Loans or SLLs are based are ambiguous or inaccurate. This green washing could harm the reputation of the company if its sustainability claims are misleading, the lender if its monitoring protocols are not meaningful, and the ESG market if the defined standards are not sufficiently ambitious.

Dialogue between stakeholders is underway to gauge what types of ESG-related disclosure and reporting are important to lenders and investors seeking to make capital available to sustainability linked products and companies. The US market is eagerly eyeing advancements made in the European market, including the European Leveraged Finance Association ("*ELFA*") working group's publication of the *Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions*, as well as the ELFA and the Principles for Responsible Investment's ("*PRI*") stated goal to publish certain sector-specific fact sheets in the first quarter of 2021, which will seek to standardize ESG information requests as part of the investment process. The Loan Syndications and Trading Association, the main industry association in the US for leveraged loans, has also now published its own standardized ESG questionnaire that is purposefully not sector-specific and was designed initially as a tool for investors and lenders to utilize during the diligence phase of a loan origination or refinancing, but can be repurposed for other information gathering and disclosure needs as well.

2. Sustainable investing: resilience amid uncertainty, BlackRock (Jan. 2021), available at https://www.blackrock.com/corporate/about-us/sustainability-resilience-research
3. The Dawn of a New ERA for ESG, LSTA (Feb. 2021), available at https://www.lsta.org/content/the-dawn-of-a-new-era-for-esg-presentation/
4. Sustainable Finance Review - Full Year 2020 – Refinitiv Deals Intelligence.

The Disclosure Conundrum

As the volume of ESG loans increases and market focus shifts to further spotlight such loans, we believe it advisable that standardization and objective monitoring protocols follow. In fact, fund managers have reported that many large investors do often request the data to back the allocation of capital to ESG investments.[5] BlackRock CEO Larry Fink has also called for global consensus of climate disclosures and has supported the efforts of the Task Force on Climate-Related Financial Disclosures working with the Sustainability Accounting Standards Board (a California-based non-profit) to create this urgently needed global standard. Meanwhile, the World Economic Forum has separately announced its own standards for ESG disclosures are forthcoming. It remains to be seen which standard will prevail in the market as all parties are becoming keenly aware of the need for predictability and true consensus here.

Accountability to stakeholders and lenders, as well as the integrity of the market, are important factors for transparency and accountability. For example, the ability to analyze a company's compliance with the negotiated performance thresholds in an SLL is essential for the structuring and administration of the loan itself – if the parties do not have reliable data and reporting, then the reflective step up/step down pricing mechanism of SLLs cannot work. To this point, SLLs have sometimes relied on third party independent rating agencies to issue ESG ratings, independent auditors to verify data, or second party opinions for comfort. Perhaps with the advent of the standardized questionnaires and with disclosure consensus trending, lenders and investors may be able to accept some company level reporting. The real cost to companies may prove to be the level of internal staffing required to comply with the growing and all important disclosure requirements.

CONCLUSION

With government and corporate attention focused on ESG initiatives and on sustainable investing, it is a matter of "when" and not "if" the loan market in the US is going to have to tackle issues relating to environmental and social accountability. Green loans and SLLs are an attempt by lenders to reward borrowers for positive environmental practices, but as the Biden agenda takes hold and ESG-related initiatives take on a heightened importance in C-suite decision making, issues of disclosure and monitoring will progress from methods of sign-posting milestones in specialty loan products to pillars of corporate governance generally.

5. *Bringing Together Company Advisers and Senior Fund Managers to Discuss ESG Disclosure, European Leveraged Finance Association and Principles for Responsible Investment, Insights Issue #12 (Dec. 8, 2020), available at* https://on24static.akamaized.net/event/29/35/88/5/rt/1/documents/resourceList1611333781094/elfainsights12bringingtogethercompany advisersandseniorfundmanagerstodiscussesgdisclosure1611333777972.pdf

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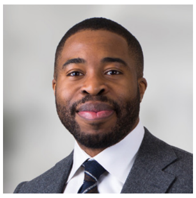

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