SLAUGHTER AND MAY/

TREASURY AND ESG STRATEGY

Part of the Horizon Scanning Governance and Impact series

How sustainable finance can support the broader business goals

Introduction

As we move into a new decade, issues around sustainability, particularly addressing the environmental impact of climate change, remain high on the political and legal agenda.

We considered how the financial markets and regulators are adapting to a sustainable economy and discussed the more familiar 'green' and 'sustainable' financial products in our recent **sustainable finance briefing**. Sustainable impact investing is now an important driver for many financial institutions. This briefing discusses how treasurers can integrate aspects of sustainable finance into the broader business model to support, where relevant, the company's sustainability strategy.

Product vs Profile

As discussed in detail in our **earlier briefing** green financial products require that the proceeds of the facility are invested in a 'green' asset or project. These have been popular with companies in 'green' industries, such as renewable energy, to finance their activities, either through a term or revolving credit facility or bond issuance. In other sectors, companies with sustainable strategies, eg investing in energy efficient technologies or in environmentally sound office buildings, have found these products can provide additional credit for that purpose, alongside the company's main credit facility.

Sustainability-linked financial products, on the other hand, align terms to the borrower's performance against an agreed set of key performance indicators ("KPIs"). Although a relatively recent product, sustainability-linked loans have become fairly prevalent in the European market. In the debt capital markets, sustainability-linked bonds have so far been less common, although that may change; the Green Bonds Principles Executive Committee, supported by ICMA, have launched a working-group on ESG-linked bonds, which intends to boost activity.

For impact investors, the product itself is important; for example, investors looking for tangible 'green' outcomes can meet this requirement by investing in a 'use of proceeds' instrument which finances the production or acquisition of a particular 'green' asset. However, increasingly, investors seem to be looking beyond the product, to focus on the general activities of the corporate in order to satisfy themselves as to the borrower's sustainability profile. The loan or bond might be labelled 'ESG', but those seeking long-term investment or who support a more transformative economy, may seek more assurances than simply specific 'green' assets or sustainability KPIs.

Investor demand

Many sophisticated investors and asset owners agree that sustainable investment strategies over the long term improve returns. A survey conducted by data provider Morningstar in 2018, found funds investing in corporates with a strong ESG focus tended to perform better, and a large number of academic studies into the relationship between ESG factors and corporate performance since the 1980s have found a positive impact on financial performance in the majority of cases (Friede & Busch). In addition, investors face increasing pressure from stakeholders not to invest in certain industries or in companies with a poor track record on ESG. Blackrock recently wrote a letter to clients in support of sustainable investing, which they are placing at the centre of the firm's investment approach, noting 'climate risk is investment risk'. Corporates who recognise these issues and can prioritise sustainability as a strategic goal, may be more attractive in a market where a holistic view of the issuer/borrower's ESG strategy is increasingly relevant.

Corporate Treasury and Corporate Strategy

In this context, it will be important for corporates to demonstrate their positive ESG-credentials to enhance value and improve access to credit. Key to this are reporting obligations. These are relevant for negotiating the particular financial instruments. They also contribute to the broader corporate strategy. Investors use these disclosures to benchmark the corporate's performance and protect against 'green-washing'.

UK and EU statutory reporting obligations have, for some time, included climate or sustainability considerations, but these have recently been the subject of renewed attention from regulators. For example, the European Union adopted the Disclosure Regulation, in November 2019, which specifies ESG disclosure requirements for financial market participants and financial advisers established in the EU. In the UK, the Government has recommended that all listed companies and large asset owners make disclosures in line with the Task Force on Climate-related Financial Disclosures ("TCFD") by 2022.

Disclosures that demonstrate how ESG-factors reflect broader corporate strategy can be an important way for investors and other stakeholders to assess a corporate's sustainability profile. For example, the LSE's Guidelines on ESG Disclosures request that issuers "explain the relevance of ESG factors to their business model and strategy. These factors should not be 'bolt-on' but an integrated component of business drivers and considerations." The TCFD Implementation Guidance recommends that when disclosing about the board's oversight of climate-related risks and opportunities, consideration should be given to disclosing, among other things, whether the board considers climate-related issues when reviewing and guiding strategy, budgets and business plans. This includes finance and capital raising decisions.

How might treasurers support ESG strategy in practice?

Products that are integrated with a company's long term green or sustainability framework might be part of the answer. For example, Derwent London PLC's recent revolving credit facility, which included a 'green' tranche, sits alongside the company's Green Finance Framework which sets out the group's sustainability objectives. The particular financial product, in this case, the green loan, was launched as part of the corporate's broader goal of long term sustainability.

Corporate ESG ratings may also become increasingly relevant to credit decisions for sustainability-linked products in particular. Treasurers may need to engage with rating agencies to discuss criteria and obtain relevant ESG scores. Currently, ESG factors tend to be taken into account in relation to specific assets; Fitch's Q3 2019 survey found around half of the lending assets covered by the 182 banks surveyed had been screened for ESG risks, but noted that "rating impacts on corporates due to ESG-related bank funding decisions" was not common. This may change as investors look to broader corporate strategy as the driver for ESG-based credit decisions.

Transition bonds

There has been some discussion around whether transition bonds might support more transformative environmental change. Unlike the sustainability-linked products discussed above, which focus on specific KPIs, transition bonds focus on an issuer's overall behaviour. The product offers financing to corporates in carbon-intensive industries looking to transition to a renewable economy, e.g. by incorporating sustainability into core operations and adapting corporate strategy to address environmental and/or sustainability challenges. They are particularly attractive for sub-investment grade credits (the green bond market has largely been comprised of investment grade issuers) and those active in 'brown' sectors such as oil. For these types of corporates which would otherwise find accessing the green finance market challenging, transition products can provide a solution. It is too early to tell whether these products could drive real change, and naturally there is some scepticism as to the limits of what they can offer. However, they have the potential to bring new players to market and encourage further discussion between issuers and investors about transformation to a lower-carbon economy.

Future developments

The lack of standardisation in terms of ESG criteria and performance has been a real challenge to the development of this market. Credit analysis has been a largely subjective exercise, as different investors have applied their own criteria from different sources to compare ESG-related performance. Regulation to encourage common standards should improve this. The European Union's Taxonomy Regulation was agreed in December 2019, and will introduce a common classification system for environmentally sustainable activity. European corporates subject to the Taxonomy Regulation will need to bear this common vocabulary in mind when developing ESG strategies and labelling financial products as environmentally sustainable. The Taxonomy Regulation's climate-related requirements are due to apply from December 2021.

On the topic of regulation, of particular interest for banks is whether there will be the opportunity for capital relief for green or ESG-investing. It is unclear whether regulators would have the appetite for this, some commentators are of the view that it is more likely that institutions would face censure for investing in certain 'brown' sectors than active relief for investing in ESG.

There is also a question as to whether investors may start to request alignment between ESG strategy and the terms of the relevant financial product. For example, green bond terms that incorporate project performance or, in the context of a sustainability-linked loan, provisions that depend on the borrower's ESG-performance beyond a margin ratchet. Generally, green and ESG financial products have tended not to include additional provisions related to ESG beyond those usually seen in a non-green/ESG-equivalent product. However, as with most aspects of green finance, this is changing. Enel's 2019 sustainable development bond included specific terms relating to the company's green commitments, as well as a margin ratchet should Enel fail to meet its targets. As this market develops and terms become more standardised under the Taxonomy Regulation, we may see more of a shift in this direction.

Overview

Climate change and sustainability as a business driver seems here to stay. According to the Institute of Sustainable Investing at Morgan Stanley, 84% of millennial investors recognise the importance of ESG. Corporates who are unable to satisfy investor expectations as to ESG performance may find access to this credit, which is estimated to be around $30trillion, more challenging. It is also important to remember that the scope of ESG goes far beyond climate-related change. Governance around diversity, gender equality, remuneration and social impact are just some of the many issues raised and no company can afford to ignore ESG on the basis that they have no environmental footprint.

ESG finance is an opportunity for corporates to really participate in building a greener and more sustainable economy, as well as offering the potential for tangible change at the borrower/issuer level. Treasurers have a crucial role to play in driving the company's related strategy.

Slaughter and May has broad experience in advising clients on all aspects of sustainable finance transactions and are closely monitoring legal, regulatory and market developments. If you would like to discuss any aspect of sustainable finance, please get in touch with your usual Slaughter and May contact.

This briefing is part of the Slaughter and May Horizon Scanning series

Click here for more details or to receive updates as part of this series. Themes include Crossing Borders, Governance and Impact, Digital, Storm Proofing and Beyond Brexit. Governance and Impact examines the rapidly evolving societal, environmental and regulatory pressures faced by today's companies.