Going green: How the financial markets are adapting to a sustainable economy

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Introduction

The global response to climate change and the focus on sustainability continues to gain momentum and there has been significant effort by national and supranational bodies to recognise and endorse the need for a green or greener economy. Examples include the European Commission's Sustainable Action Plan, the UK's Green Finance Strategy and the UN's Sustainable Development Goals as well as a number of sovereign green bond issues both launched and in progress. These, and many other initiatives, seek to connect the public and private sector in mitigating the effects of climate, environmental and sustainability challenges via systemic change in the global financial system.

The benefits should, in theory, flow in all directions. The UK Prudential Regulation Authority (**PRA**) 2018 review of the UK banking sector found 70% of banks consider climate change to be a financial risk and that the benefits of operating businesses with a view to sustainability should provide long-term economic benefits. The potential for opportunity and innovation in this space should not be underestimated. As the green economy evolves, the finance industry will have a vital role to play in shaping how the credit markets adapt to this new landscape and drive it forward.

This briefing discusses the more common green and sustainability-linked financial products and how the market is leading innovation in this area. It also gives a brief summary of the legal and regulatory responses, particularly in the context of climate-related reporting obligations.

Green and sustainability-linked financial products

Products described as 'green' (ie green loans and green bonds) have conventionally been understood to refer to the use of proceeds being invested in 'green' projects. To meet this criteria, investors would need to be satisfied that there are clear environmental benefits to the particular project. During the life of the bond or loan, investors would also expect to receive independent impact assessments that would certify that the project continues to satisfy its green credentials.

By contrast, sustainability or ESG (environmental, social and governance) linked products (sometimes referred to as 'Sustainability Linked' or 'SSLP'), look to align terms to the borrower's performance against an agreed set of ESG-related performance targets. For example, the margin on an ESG facility adjusts if the borrower meets such targets; for investment grade borrowers, the average adjustment is 2.5bps in either direction depending on whether or not the targets are met. An independent second party opinion provider would typically be engaged by the borrower to verify whether or not the pre-determined targets are satisfied. Verification would also be necessary for a green 'use of proceeds' project to assess the merits of the particular product, which can be a more straightforward assessment given it often focuses on specific assets.

The use of proceeds of an ESG-linked product will not be relevant in determining whether or not the particular performance targets are met so it is fairly common to see these types of facilities used for general corporate purposes. These products have the potential to be a useful and effective way for borrowers and issuers to make a positive ESG impact at a cheaper cost of capital, particularly if specific green use-of-proceeds financing is not an option.

Investors and asset owners and managers have been important drivers in supporting the development of a green financial marketplace, with a number of financial institutions aligning their lending portfolios to green/ESG principles. For example, in 2018 ING announced a sector based approach to meeting the goals of the Paris Accord. Other institutions have pledged support to sustainable investments; BNP Paribas has committed to doubling its investment in renewable energy to €15bn by 2020 and plans to invest €100m in start-ups specialising in energy transition and many others have established green and sustainable lending platforms. The message seems to be that there are plenty of opportunities for those corporates looking to access credit via green and ESG-products.

The steady growth of the green bond market indicates that the 'use of proceeds' model is now fairly well understood and accepted. This has been supported, in part, by the development of various green bond and loan frameworks with clear guidelines for what would constitute a 'green' investment, e.g. ICMA's Green Bond Principles and the Green Loan Principles produced by the LMA, APLMA and LSTA. According to Moody's, green bonds currently represent the largest green financial product by volume; the first quarter of 2019 saw green bond issuances account for 2.5% of global issuances, a 40% year-on-year increase which Moody's have said they expect to continue. The London Stock Exchange currently lists over 100 green and sustainable bonds on its markets and has recently concluded a consultation on developing a new sustainable bond market comprising segments for green, social and sustainable bonds as well as for certified issuers who independently meet certain green/ESG standards.

There is currently more flexibility around the ESG-linked product. Whether or not an activity would be considered to fall within ESG parameters is arguably subjective and there may be challenges in determining whether or not a borrower or issuer has met relevant performance targets. The Sustainability Linked Loan Principles, produced by the LMA, APLMA and LSTA, and ICMA's Social and Sustainability Bond Principles, go some way towards creating common principles, but accusations of 'greenwashing' have been made more often in the context of ESG finance. The EU's incoming sustainable finance taxonomy, which will provide a legislative classification tool for green/ESG-products and markets, may also help in developing a more objective framework, supporting the work already undertaken by ICMA, the LMA and others. However, any formal codification for an ESG-linked product may risk limiting innovation and undermine the flexibility the product offers.

The legal and regulatory response

While there has been great support for green financial products, there remains a significant way to go in developing a green economy which can enable long-lasting systemic change. The UK Government's ambitions for 'greening the economy' are set out in its Green Finance Strategy (**GFS**), published in July 2019, the aims of which are supported by the Financial Conduct Authority (FCA), PRA, Financial Reporting Council and Pensions Regulator. The proposals focus around ensuring climate and environmental risk factors are fully integrated into mainstream financial decision making across all sectors and asset classes. It goes beyond the funding of green projects and envisages the development of robust markets for green financial products.

To date, the green/ESG financial product has been largely market driven; issuers or borrowers who wish to utilise capex for green projects or build sustainable frameworks around their business have generally done so according to the broad principles laid out by ICMA and the LMA etc. However, questions have been raised as to how far this market can develop given the lack of transparency and comparability between the players and the regulatory response so far has focussed on addressing these challenges. For

example, there are suggestions that second party opinion providers, responsible for verifying a 'green' project or whether or not ESG-linked performance targets are met, should be subject to regulatory supervision.

The FCA recently published feedback on its 2018 discussion paper on climate change and green finance (**FCA Consultation**) which considered a number of potential steps around developing common standards and metrics. An important aspect relates to climate related financial disclosures. Corporates subject to the Non-Financial Reporting Directive will be familiar with requirements to report on the ways in which their activities impact the environment as well as disclosures which capture financially material climate-related risks on that company. In relation to the latter, the FCA queries how meaningful these disclosures can be, particularly around a perceived lack of consistency in, for example, materiality and terminology given the particular nature of climate-related risks. The Government perspective, echoed by the regulators, is that to encourage the development of the green economy there needs to be a greater degree of consistency and comparability. To that end, the GFS proposes that all listed companies and large asset owners, irrespective of whether they are engaged in green/ESG-finance related activity, will make disclosures in line with recommendations of the Task Force on Climate-related Financial Disclosures (**TCFD**) by 2022. This would mean that such organisations would be required to make climate-related financial reporting, with a focus on the risks and opportunities they face as a result of the transition to a lower-carbon economy.

The FCA intends to consult in early 2020 on the GFS proposals to introduce TCFD-aligned disclosures as well as considering whether disclosures should extend beyond climate-related factors to other sustainability measures. It is not clear yet what these disclosures might look like, although traditional rating agencies have begun to introduce ESG metrics into their rating profiles which could influence the types of disclosures that the market adopts. For example, Fitch Ratings recently launched an 'ESG Relevant Score' which discloses how ESG factors directly affect a company's credit rating. The ESG Relevance Scores will be sector based and entity specific and it remains to be seen whether this will support transparency and consistency market-wide. Interestingly, while much of the publicity in this area has focussed on environmental factors, social and governance indicators have been more prominent in the compiling of corporate ESG ratings so there is some basis for alternative frameworks.

Whether regulated entities become subject to their own reporting or other regulatory requirements in relation to green or sustainable finance also remains to be seen. The FCA Consultation included questions on this and the majority of respondents agreed with introducing some form of climate-related disclosure regime. Should such measures be introduced, this would likely impact the various products, particularly in relation to investor protections.

Whatever regulatory steps are taken, there will need to be a balance struck between allowing the market to continue to innovate with relative flexibility while ensuring it is conducted in a transparent and genuine manner. Currently, the TCFD is a voluntary disclosure framework and it is unclear whether legislation will be introduced to require mandatory reporting in line with the TCFD and GFC recommendations; the FCA Consultation observed a split between stakeholders preferring a 'comply and explain' approach or a strict 'comply' approach to encourage consistent disclosures. The European Commission's Sustainable Finance Action Plan also incorporates a series of non-binding guidelines to support its objectives of directing capital flows towards sustainable investment, managing financial risks stemming from climate change by considering ESG factors in financial decision making and increasing transparency in financial products.

However, regulators have shown willingness to compel action to support the government's green ambitions. Since October 2019, occupational pension schemes have been required to publish their policy on financially material considerations, including those relating to climate change and ESG issues in line with recommendations from the Green Action Taskforce and the PRA have published Supervisory Statement 3/19 'Enhancing banks' and insurers'

approaches to managing the financial risks from climate change' which details the PRA's expectations of firms in this context, including in relation to governance, risk management and scenario analysis. Given government and regulatory focus on developing more efficient and transparent markets to support green and ESG investments products, we would expect that going forward corporates will continue to be scrutinised over their reporting obligations in this area.

Innovation and adaptability

While a certain level of standardisation is desirable for stakeholders, flexibility in the model encourages innovation. For example, ESG-linked loans have been in the market since 2017, but ESG principles are increasingly being seen in other contexts. ENEL's recent $1.5bn sustainability-linked bond is the first bond product where the coupon incorporates a margin step-up if the issuer fails to meets certain ESG targets. Recent ESG-linked schuldscheine and USPP have also been issued and AFME is developing principles to support 'green securitisation'.

Corporates are also adapting sustainable or green targets to suit their particular business needs and goals. In the ESG space in particular, performance targets are moving beyond a traditional understanding of 'green'. The Co-op's recent sustainable bond met the UN's Sustainable Development Goals with the proceeds of the issue supporting Fairtrade producers. Other recent examples of ethical investment with a potentially wider scope include access to education and crime prevention, illustrating the use of the sustainability model beyond the 'dark green'. In the public space, the World Bank's 'pandemic bond' issue, linking investment to the spread of deadly pandemics is another example of creative uses of the product, although there have been questions as to its effectiveness in raising finance to battle the crises. The Rhino Impact Bond, expected to launch in early 2020, will become the first financial instrument linked to species conservation. Investors will receive their capital and coupon provided the black African rhino population increases, with the yield dependent on the level of population growth.

As investors increasingly take an interest in companies with ESG or green considerations, borrowers and issuers have the potential to tailor the sustainability template to meet their specific needs while enhancing access to credit. Support for a greener economy at a government and regulatory level can be expected to continue on a similar trajectory. The UK government is expected to issue an interim report in 2020 as a follow up to the GFS, which may shed light on any future legislative steps. With climate change and sustainability so much in the public gaze, further statutory support for the greener economy is likely to follow.

Slaughter and May has broad international experience in advising clients on a range of green finance transactions, including green bond issuances and green and ESG-linked syndicated loans and related issues. We are closely monitoring developments in the green economy, including in the legal and regulatory sphere. If you would like further information please contact your usual adviser at Slaughter and May.

Please also see some suggested reading materials that are referred to in this briefing.

- Green Bond Principles, Social Bond Principles and Sustainability Bond Guidelines (ICMA) (June 2018)
- Green Loan Principles (LMA, LSTA and APLMA) (December 2018)
- Sustainability Linked Loan Principles (LMA, LSTA and APLMA) (March 2019)
- Government Green Finance Strategy (July 2019)
- FCA Climate Change and Green Finance: summary of responses and next steps (October 2019)

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