Key Takeaways

What is the Future of ESG in Corporate Debt Markets?

ESG Center Governance Watch Webcast

May 21, 2024 | Virtual Panel Discussion

On May 21, the ESG Center held a Governance Watch webcast on ESG in debt markets which focused on:

- Where does ESG fit today into bond markets and bank lending, including sustainability-linked and mainstream debt instruments?
- What forces will shape the future of ESG in debt markets, including regulation?
- What are the lessons learned thus far in ESG-related debt?
- What opportunities lie ahead for creditors and corporate borrowers?

Below are the key takeaways from the webcast, which was generously supported by our Knowledge Partner **Cleary Gottlieb Steen & Hamilton LLP.**

Speakers included:

- **Kristi Z. Eberhardt,** Managing Director & Head of Sustainable Finance, PNC Financial Services
- **Michael Ferguson,** Americas Team Leader – Sustainable Finance, S&P Global Ratings
- **Duane McLaughlin,** Partner, Cleary Gottlieb Steen & Hamilton LLP
- **Thomas Yagel,** Chief Operating and Product Officer, S&P Global Sustainable1

Current Trends in ESG and Sustainability in Corporate Debt Markets

1. **Environmental, social, and governance (ESG) factors remain influential in corporate debt markets, despite persistent concerns over backlash and cooling investor demand**. Companies with strong ESG credentials can potentially benefit from more favorable borrowing costs and terms.

2. **Sustainability-linked loans are experiencing a significant downturn.** In 2023, sustainability-linked loan (SLL) issuance decreased by 77% in the US, with even lower volumes thus far in 2024. This decline can be attributed to a challenging macroeconomic environment and increased regulatory scrutiny, as well as companies needing to align with new ESG goals now that 2025 goals are approaching, coupled with tighter principles around ambition and materiality. The “greenium” associated with ESG borrowing may also have been eroded by the cost of annual audits associated with SLLs. However, despite overall decline, there has been an increase in SLL adoption among US companies with foreign parent companies.

3. **ESG interest is growing in private markets.** The permeation of ESG considerations in private markets is also challenging from an investment perspective, due to a lack of uniformity and diverging disclosure practices. Market participants are trying to ensure harmonization in private markets but require private lenders to also align with ESG standards.

4. **Corporate net zero targets are under growing scrutiny and are often perceived by investors as not tied to actual plans and spending**. Investors want to see companies working tangibly toward these goals, as companies not making progress now are less likely to hit interim and final targets. Without proper incentives for managers, companies will find it difficult to advance toward net zero commitments. Environmental targets need to be science-aligned, but companies do not necessarily need to commit to a Science-Based Target (SBT). Since scope 3 emissions are hard to calculate and set targets against, companies further along in their sustainability journeys are focusing on just one, or a few, material Key Performance Indicators (KPIs) for scope 3 categories. Particularly in travel or supply chain emissions reductions. Overall, decarbonization is not slowing down.

5. **There is untapped potential for social (S) initiatives in corporate debt markets.** Regarding social KPIs, transactions with goals around women in leadership and diversity in hiring were previously common. There is growing sensitivity in diversity-linked KPIs due to DEI backlash. Interest is increasing in front-line labor and safety KPIs. While the "E" space is fraught by concerns about standardized reporting and regulation, there are big opportunities in "S." It will be interesting to see how this develops, particularly in loan space. "S" issues are already very core to many corporates – in workforce, and other institutional objectives. Over the next few years, lenders should closely monitor how this space develops.

The Future of ESG and Sustainability in Corporate Debt Markets

6. **Companies are expanding the scope of their ESG frameworks and strategies (driven in part by IRA) which in turn is expanding financing options and creating new opportunities for investors.** Companies are updating frameworks to include areas such as nuclear energy, carbon capture and green hydrogen, influenced in part by incentives provided in the Inflation Reduction Act (IRA). Additionally, companies with established green bond frameworks are incorporating new social components, like access to basic services. This trend is leading to broader and more ambitious ESG frameworks.

7. **The middle market is an important sector for future decarbonization efforts**. Companies in the middle of the value chain, and private suppliers to larger corporates with decarbonization initiatives, are increasingly receiving emissions-related inquiries from market actors. These firms are often unprepared to respond due to a lack of data or the belief that it is not relevant for the business. Companies must be prepared to address emissions questions to remain competitive in the value chain.

8. **Evolving ESG and sustainability regulations will likely drive an increase in ESG financing**. Global regulations are broadening in scope and impact, reaching deeper into companies' value chains. Corporations must adapt to complex new requirements, such as the SEC's enhanced climate-related disclosure rules, California's new climate disclosure laws, and Europe's Corporate Sustainability Reporting Directive. Enhanced disclosure regulations will increase appetite for more uniformity in ESG reporting, as both corporates and investors demand information that is comparable and harmonized.

9. **ESG regulations and new disclosure requirements will also drive standardization of KPIs, transparency in claims and statements, and verification of data.** For sustainable debt financing, ESG information must be reported, and should be audited and verified. Because of this, there is a growing need for consensus around how ambitious targets should be, and what KPIs companies should be using. While standard-setting bodies such as the International Financial Reporting Standards (IFRS) Foundation have been leading the charge in this area, regulated reporting alleviates concerns that companies are only targeting low-hanging fruit. The more formal regulation there is, the more uniformity there will be in reporting, leaving companies unable to hide from uncomfortable metrics.

    a. The SLL market has faced slow growth in the US and some stagnation in Europe because the metrics being utilized are not seen as material to companies, or ambitious in general. Stronger

regulation will help assuage these concerns, as well as apprehension surrounding greenwashing, and drive activity in sustainable debt products.

b. Verification of reported information is just as important. Scrutinizing investors are interested in timeliness, credibility, and assurance of reporting. The burden of proof is falling on companies to prove their activities are green. Investors are concerned about their own footprint and want reliable data and information.

10. **Hard-to-abate industries (the sectors most difficult to decarbonize) will likely attract increased investment as demand intensifies for action on emissions across economies.** Sectors with clear pathways to net zero emissions (such as renewable energy and electric vehicles) have always been a major focus of sustainable finance. Hard-to-abate industries (such as aviation, shipping, steel, cement, and chemical production) are, by definition, more challenging to decarbonize due to their physical, technological or market particularities. These sectors require differentiated and innovative financial products, such as transition bonds or new instruments beyond sustainability-linked bonds (SLBs), to address their unique challenges. Multilateral development institutions such as the World Bank are often leaders in driving innovation in this space (for example, "outcome bonds" that link investor returns to tangible sustainable development outcomes.)

11. **While the 2024 US elections will likely influence the issuance of sustainable finance, green activity is expected to continue due to a range of societal, regulatory, and market forces.** Between the IRA and substantial state level investments, there is a huge appetite for sustainable projects, and for the market's demand for decarbonization will likely not slow down. Companies should continue to monitor changing political headwinds and legal sensitivities to navigate this landscape effectively.

12. **ESG financing is here to stay but will continue to evolve and adapt**. Despite recent market challenges, opportunities are emerging. The sustainable debt market hit $5 trillion in early 2024, and the sustainable bond market is projected to hit $1 trillion by the year-end. Long-term interest from investors will drive the need for long-term action. From refinancing existing debt with ESG features, to taking on new ESG debt, companies need to plan ahead, select advisors carefully, and have a realistic sense of cost, as well as maintaining a thoughtful and credible sustainability framework.