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ESG Diligence in Loan Markets

Update

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Environmental, social and governance (ESG) considerations are continuing to come under increased scrutiny in the loan markets. Topics such as climate change, composition of corporate boards and treatment of employees by corporations are at the forefront of individual and corporate consciousness, particularly in view of the impacts of the COVID-19 pandemic on the global workforce. Tailored financial products such as sustainability-linked loans, which reward favorable ESG behavior by corporates through step-up/step-down pricing mechanisms, have gained huge popularity since their inception, and the demand for ESG investment options is expected to increase through 2021. However, fundamental hurdles remain to mainstreaming ESG in the loan markets due to a lack of standardization around ESG reporting, resulting in inadequate ESG disclosures. This makes it difficult for prospective investors and lenders to fully evaluate a company's overall risk profile and make informed investment decisions, particularly where a company is not publicly traded and little relevant information about that company is otherwise readily available.

The New York-based Loan Syndications and Trading Association (LSTA) convened a specific working group to discuss how to mitigate potential ESG risks, which resulted in, among other things, the design of an ESG Diligence Questionnaire (the "Questionnaire") in February 2020. The Questionnaire, which is intended to be completed by borrowers during the loan origination process (but may also be used for any capital transaction, including in the context of refinancings), was developed with the goal of soliciting reliable ESG information from borrowers. It offers a set of questions that, once completed, will provide prospective lenders with an overview of that borrower's ESG or sustainability "story". As stated in the preamble to the Questionnaire, it is intended that completed questionnaires are "*posted to the relevant data room (the public side if one exists) and available for review by prospective lenders*". The LSTA has also published a helpful FAQ document which

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provides additional information on the Questionnaire and what it seeks to achieve. (Both documents are available for download by LSTA members on the LSTA website)

The Questionnaire comprises eight questions within four general sections, which we summarize below. The questions are necessarily broad to cater to companies in the early through advanced stages of ESG implementation, and to allow borrowers to identify certain ESG concepts and goals relevant to their business, with the understanding that ESG or sustainability will mean different things to different companies. Companies with nascent policies or plans, and even those without a formal policy, with respect to ESG should not be discouraged from completing the Questionnaire, but should view it as an opportunity to develop an understanding of ESG as it pertains to their business.

1. ESG Governance. This section is aimed at providing lenders with an understanding of how advanced a borrower is in its ESG journey. Questions include whether the borrower currently has an ESG policy, and if so, any measures in place for tracking progress, and if not, any plans the borrower has in relation to ESG, and whether any ESG-related reporting is made available. It also asks the borrower to identify the individual(s) responsible for monitoring ESG issues and their level of seniority, including whether ESG is considered in relation to management performance evaluation or compensation.

2. Relevant ESG Frameworks. This section asks the borrower to identify any recognized ESG frameworks and standards to which it adheres. A list is provided by the LSTA in the Questionnaire, and includes frameworks such as the UN Sustainable Development Goals (SDGs) and the Recommendations of the Task Force for Climate-related Financial Disclosures (TCFD). An "*Other(s)*" option is available whereby borrowers can provide any other frameworks and standards that they have adopted or to which they adhere. Participation in these frameworks, alongside other factors, can indicate a company's commitment to ESG integration, particularly when combined with measures for tracking progress towards achieving verifiable ESG goals.

3. Relevant ESG Factors. This section asks the borrower to do a deeper dive into its ESG activities by providing a breakdown of the environmental, social and governance issues specific to its business/industry, its approach to determining the composition of its board, management and workforce, and how performance in each of these categories is being tracked or measured. Companies may find it helpful to refer to the Sustainability Accounting Standards Board's (SASB) Materiality Map (SASB Materiality Map), which is an interactive tool that identifies the specific ESG issues that are most likely to have an impact on the financial condition or operating performance of a company within an industry. Additionally, the European Leverage Finance Association (ELFA) and the Principles for Responsible Investment (PRI) jointly launched certain sector-specific "ESG Fact Sheets" in January 2021 (with further fact sheets covering other sectors to be published over time), to assist borrowers to prepare disclosures (ELFA ESG Fact Sheets).

4. Breakdown of Company Revenue. The final section includes a list of business activities, and asks borrowers to identify the percentage of their exposure to the same (to the extent applicable, under 10%, 10-50% or over 50% exposure). The LSTA emphasizes that the question "*is not intended to make a value judgment*" on such activities, but to aid asset managers in their investment decisions, and to allow them to select eligible borrowers for ESG-mandated allocations.

Due to the economic slowdown in the second quarter of 2020 as a result of the COVID-19 pandemic, more time is needed to fully assess the role of the Questionnaire in having facilitated greater ESG disclosure to date. Many deals that were closed in 2020 were distressed transactions or rescue financings; *i.e.*, circumstances under which the Questionnaire would not typically be requested. Nonetheless, we understand from the LSTA that, as of September 2020 they were made aware (on an anecdotal basis) of approximately 60 transactions in which the Questionnaire was completed by borrowers, and that the quality of responses provided has improved over time. From an investor or lender perspective, any information provided by borrowers is indisputably better than none. We expect usage of the Questionnaire to increase in 2021, particularly if it becomes a standard part of the diligence materials requested by lenders prior to loan origination (or other capital transaction, if applicable). The LSTA suggests that best practices would be for the completed questionnaires to be posted to data rooms rather than for disclosures to be made purely on a bilateral basis, in the interest of facilitating greater information-sharing among lender syndicates.

ESG diligence is here to stay and is something that borrowers should be actively prepared to address and discuss with prospective lenders on an ongoing basis. The Questionnaire, currently an initial version, is likely to evolve to incorporate feedback from LSTA members on its usage and to reflect market developments in ESG, particularly as more information becomes available on the specific risks facing companies. Moreover, there is a continuing global effort to create more streamlined guidance on ESG reporting and disclosure; for example, the International Financial Reporting Standards (IFRS) Foundation sought input (with comments requested by December 31, 2020) on the need for a global set of internationally recognized sustainability standards, and how it might contribute to the development and oversight of the same (IFRS Comments on Sustainability Reporting), and five of the ESG framework- and standard-setting instructions declared an intention to collaborate to align their respective frameworks and standards (Impact Management Project Statements on Reporting). In the meantime, the LSTA's Questionnaire represents an important step to initiate a solid diligence process and to mitigate the currently complex sustainability reporting landscape as the market works towards standardization and comparability of reporting for ESG.