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SUSTAINABLE FINANCE: LOOKING TO 2024

GOVERNANCE & SUSTAINABILITY
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The sustainable finance market experienced its first year-on-year contraction in 2022, as inflation, higher borrowing costs, geopolitical tensions and general economic uncertainty depressed activity in most sectors of the debt markets. Although these challenges remained, during 2023 sustainable finance volumes showed signs of recovery. Global sustainable finance issuance totalled $717bn in the first half of 2023 alone, an improvement on the second half of 2022.

Green bonds have been the driving force of this recovery, with global green bond issuance in the first half of 2023 reaching $310bn, the highest half-year total since the inception of the green bond market. Sustainability-linked products have performed less well. Overall volumes of sustainability-linked loans (**SLLs**) and bonds (**SLBs**) have struggled to reach even 2022 levels.

As we enter 2024, there are questions around the future of the sustainable finance market, and perhaps more importantly how the different product categories will fare. Will green bonds continue to dominate? Does the more recent uptick in SLB issuance (in the context of a very quiet year for SLBs) signal good times ahead? Will the upcoming wave of refinancings prompt a surge in SLL volumes? Is an increase in activity the inevitable result of the sustainable finance targets which most of the larger financial institutions have now set for themselves?

Wherever the figures end up in 2024, sustainable finance products and their evolution will remain a key focus area for finance and treasury teams across sectors and jurisdictions, with the flow of legal, regulatory and market developments showing no signs of slowing down. Below we consider some of the developments in sustainable finance to anticipate in 2024.

DEVELOPMENTS IN THE GOVERNANCE AND REGULATION OF SUSTAINABLE FINANCE PRODUCTS

Sustainable finance products have, until recently, been governed exclusively by voluntary recommended guidelines published by the LMA and ICMA.

2023 saw the first step towards more formal regulation of the market with the finalisation of the EU Green Bond Standard (**EU GBS**), a voluntary "gold" standard available to all green bond issuers in and outside Europe which will begin to apply from the end of 2024 at the earliest. There are no immediate plans to adopt a similar standard in the UK or US, but regulators around the world will no doubt be keeping a watchful eye on how far the EU GBS goes to improving the effectiveness, transparency and credibility of the green bond market, not least in the face of questions around its usability and adoption (discussed further in our client briefing here).

In the meantime, the debt trade associations are expected to continue to take the lead in the governance of sustainable finance products. The LMA and ICMA will be keeping their voluntary principles under review in the coming year, and each has several supplementary projects in the pipeline to support the growth and integrity of the market.

Increased regulatory scrutiny can, however, be expected. Earlier this year, the UK's FCA **outlined various concerns with the operation and integrity of the SLL market**, stating that it will continue to monitor the market with a view to considering the need for further measures as necessary. In the bond market, it is expected that

sustainability disclosure requirements will be introduced for bond prospectuses as part of upcoming UK and EU prospectus regulation reforms, with ESMA having already outlined initial guidance for EU prospectuses.

INCREASED FOCUS ON MITIGATING GREENWASHING RISK

2023 saw a marked increase in greenwashing allegations. While the bulk of these claims have not arisen in a sustainable finance context, the unwavering focus on, and discussion of, greenwashing in a wider sustainability context has brought the risks within the sustainable finance market to the fore.

There is no agreed definition of greenwashing but in a sustainable finance context it typically manifests as the inappropriate use of the green, social or sustainability-linked product label, and can have significant reputational consequences.

Greenwashing concerns amongst sustainable finance market participants tend to manifest in increasing focus from lenders and investors on the materiality of KPIs and ambitiousness of SPTs in a sustainability-linked context, and of the green/social credentials of projects in a "use of proceeds" context, to ensure that ESG labels are being applied appropriately. Contractual protections sought by lenders in SLLs with a view to protecting against greenwashing, for example ESG amendment and declassification provisions, have become more widespread and detailed over the last year. Contractual protections along these lines are expected to evolve further as the market develops.

Mitigating greenwashing risk is, of course, of equal concern to borrowers and issuers. Risk mitigation is predominantly focussed on compliance with the relevant LMA/ICMA voluntary guidelines, which specify robust reporting and external verification processes. Compliance with these reporting and verification requirements requires treasury functions to collaborate with their wider sustainability teams. The upskilling of financing and treasury personnel in relation to the company's ESG strategy, risks and reporting requirements has become a priority for many businesses, both to mitigate greenwashing risks and to ensure that ESG messaging that comes into the public domain is robust and consistent.

INCREASED LENDER AND INVESTOR SCRUTINY AND DUE DILIGENCE

Increased ESG-related due diligence and scrutiny from lenders and investors of the ESG profile of borrowers and issuers has, in recent years, become a feature of all finance transactions (not just those with an ESG label). This is an area that continues to develop, driven in part by evolving reporting requirements (in the UK, the EU and internationally), as well as reputational pressure on the financial sector to lend responsibly and avoid greenwashing (as discussed above). This focus is set to continue into 2024.

Lender/investor due diligence, up until quite recently, has been heavily focussed on climate considerations. More recently (in light of the publication of the final TNFD recommendations) there has been greater focus on nature and biodiversity risks and strategies, and increasing discussion of the need to bring the 'S' and 'G' in ESG to the fore.

On climate-related matters, scope 3 emissions have become a particular focus for lenders and investors, who are increasingly asking borrowers and issuers for disclosures as well as the inclusion of scope 3 emissions targets in a sustainability-linked context. A lack of reliable data has, up to now, hampered many borrowers and issuers, but as reporting requirements expand and data flows improve, an uptick in scope 3-related disclosure and targets is foreseeable in the coming year. In the absence of available data, borrowers and issuers can expect to be put under pressure to indicate the timeframe within which such data will be available.

Increased focus on the role of transition plans in sustainable finance products is also expected in 2024, especially in the UK, following the launch of the Transition Plan Taskforce's Disclosure Framework in October 2023 and ongoing discussion around future legislative/regulatory requirements in relation to transition plans.

Access to financing for those in carbon-intensive sectors has become a key area of contention. Some lenders and investors, faced with overwhelming pressure from stakeholders, have over the course of 2023 adopted increasingly restrictive lending and investment policies with regards to these sectors. Where funding continues to be available, it is frequently conditional on having a robust and credible transition plan in place, a requirement which it seems likely will be extended to further sectors in the coming year.

The impact of ongoing work to regulate ESG rating providers, both at UK and EU level, on lender/investor due diligence also remains an area to watch in 2024, although it seems most likely that, if anything, ESG ratings will simply serve to supplement rather than replace existing due diligence processes.

DEVELOPMENTS IN THE STRUCTURE AND TERMS OF SUSTAINABILITY-LINKED PRODUCTS

The SLL and SLB products are conceptually accessible to a wider range of borrowers and issuers when compared to "use of proceeds" products, but this has not translated into volumes of sustainability-linked products (SLBs in particular). The 2023 recovery of SLL/SLB activity has been significantly weaker than, for example, the green bond market.

Faced with the same macro-economic and political headwinds, it is clear that the sustainability-linked market is facing deeper-rooted challenges which need to be addressed to facilitate further uptake and growth.

Nervousness from lenders, investors and regulators around the credibility of the asset class, particularly SLBs, has contributed to the reduction in volumes. The debt trade associations have sought to address this challenge through updates to their principles and accompanying guidance in 2023.

Reticence to issue sustainability-linked products currently appears more apparent on the borrower and issuer side. Sustainability-linked products, considered by early movers as an effective way for businesses to demonstrate their commitment to sustainability, may now not be viewed as critical, with wider corporate sustainability strategies and disclosures adequately fulfilling this role.

This is against the backdrop of very thin economic incentives to adopt sustainability-linked structures. As identified by the UK's FCA as part of its review of the SLL market mentioned above, the economic incentive structure for sustainability-linked products is weak, with margin discounts minimal (and increasingly so as a proportion of now higher borrowing costs).

This, coupled with the increasingly stringent reporting and verification requirements involved in sustainability-linked structures laid down in the latest LMA/ICMA principles (which no one disputes are important in protecting the integrity of the market but no doubt impose a greater burden on borrowers and issuers) and the extra scrutiny and greenwashing risk that comes with issuing a sustainability-linked product, and the calculation for borrowers and issuers is perhaps no longer what it was. Whether a reassessment of the incentive structure (in particular in the leveraged and other sectors of the loan market where relationship pricing is less apparent) might tip the balance for borrowers and issuers is a question that many have started to ask.

In addition to the incentive structure, the terms of sustainability-linked products, which are still relatively new and untested, have also been under the spotlight in 2023 to ensure they provide necessary levels of protection to lenders and investors (see the discussion on greenwashing above) as well as supporting the integrity of the wider market. ICMA recently added to its SLB guidance in this regard and, in May 2023, the LMA published template drafting for SLLs which addresses a number of these concerns. SLL and SLB terms will continue to evolve in 2024, with the direction of travel towards greater detail and complexity.

With sustainable finance now an established feature of the debt markets, the question of whether and how best to engage with the products available has become a question that is routinely considered by all market participants. 2023 was a testing year overall for the sustainable finance market. While there are some signs of recovery, aggregate volumes of sustainable financing mask an interesting dynamic at play, one in which green bonds have dominated and sustainability-linked products have lagged behind. Under pressure to increase volumes, we expect that lenders and investors will take steps to respond to product-specific challenges, supported and driven by efforts from governments, regulators and industry bodies, in recognition of the key role sustainable finance has been designated in advancing the wider sustainability agenda.

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