SLAUGHTER AND MAY/

PATH TO COP26: HOW CLIMATE CHANGE AND OTHER ESG ISSUES IMPACT THE DEBT CAPITAL MARKETS

Governance, Sustainability & Society – Part of the Horizon Scanning series

Introduction

The most important question facing the debt capital markets relates to whether and how the structures, documentation, practice and regulation associated with the issuance of debt securities should be amended to combat climate change and tackle other environmental, social and governance (ESG) issues.

This question concerns each and every player in the debt capital markets: issuers, advisors, investors, trading venues and regulators. It is also relevant to each and every product: investment grade standalone Eurobonds, MTN programmes, high yield bonds, equity-linked debt, regulatory capital instruments, corporate hybrids and short-term debt and commercial paper. As the clock counts down to the COP26 conference taking place in Glasgow in November, focus on this question will increase and for UK issuers in particular, the debut UK Green Gilt issuance scheduled for September is likely to catalyse further the labelled bond market.

In this briefing we address this question and focus in particular on what it means for issuers of debt securities.

Key Points

- In order to tackle climate change and other ESG issues, we may need to change the way that we think about debt securities. In addition to credit risks, risks and opportunities related to climate change and other ESG issues may need to be appropriately disclosed.
- New obligations that impact asset managers do not impact issuers of debt securities directly. However, issuers are increasingly feeling their indirect impacts via targeted questions coming from asset managers.
- There is an open question over how issuers of debt securities should disclose climate change and other ESG risks and opportunities within their public offer documentation. Issuers should consider the changing landscape for both regulatory requirements and market practice.
- The labelled sustainable bond market continues to grow and innovate rapidly. For issuers, understanding investor expectations and prioritising clear disclosure are key to a successful issuance.
- To date the labelled sustainable bond market has been led by market innovation rather than regulation. This is now starting to change as policy-makers increasingly consider implementing new regulation and reforming existing regulation to deal with labelled sustainable debt securities.

Should climate change and other ESG issues change the way we think about DCM?

Traditionally, investors in debt securities have invested for pure economic reasons: their key concern has been being paid interest and repaid principal. What an issuer does with the issuance proceeds or what it does generally with its business has only been a concern for investors to the extent that an issuer's creditworthiness is impacted.

The entire body of documentation, practice and regulation of the debt capital markets has therefore been built around credit. For example, contractual mechanisms within documentation such as undertakings and events of default concern payment obligations and solvency-related events. Statutory and common law heads of liability for issuers (such as misrepresentation, breach of contract and liability for published information) occur only when investors can show that they have suffered a loss, normally seen in economic terms. Regulatory requirements for disclosure under the prospectus regime are designed to ensure that an investor can analyse an issuer's creditworthiness and it is market practice for risk factors for offering documents to focus on risks that affect an issuer's ability to fulfil its obligations under the securities (which are again normally economic obligations).

To the extent that investors are now investing in debt securities for reasons that go beyond pure economic reasons – for example, to achieve certain climate change mitigation or adaptation or other ESG-related outcomes – this represents a revolutionary change. If the interests of investors no longer relate strictly to an issuer's credit, perhaps the entire body of debt capital markets practice and regulation should be amended to reflect the changed needs of investors. Beyond investor concerns, arguably debt capital markets may need to adapt to reflect changed Governmental and social objectives.

Green finance or financing green?

When considering how climate change and other ESG issues impact the debt capital markets, it can be helpful to distinguish between two categories of measures, which are often considered separately. Using language adopted by the UK Government's green finance strategy, these are:

(1) ***Greening finance***: these measures relate to the financial system as a whole and therefore to all debt securities, however they are labelled. They include requirements for and practice around climate change disclosure and how obligations which apply directly to regulated investors impact all financial products, potentially also impacting issuers of debt securities indirectly. Many of these measures relate to questions of disclosure and transparency. Good disclosure of climate change and other ESG impacts should theoretically result in better allocation of capital, as well as better protection for consumers and other market participants. But what exactly is good disclosure?

(2) ***Financing green***: these measures relate to how climate change mitigation and adaptation or other ESG-related projects can be financed. They include certain market-led and legislative solutions for how conventional debt securities can be adapted (and accordingly labelled) to reflect their specific purposes. These highly innovative labelled products have moved from the fringes to the mainstream in recent years. They are also designed to ensure capital is allocated appropriately, but in addition to questions of disclosure, the key questions tend to relate to what is the appropriate contractual balance between issuers and investors and whether market solutions are sufficient or need to be supplanted by regulation.

'Greening finance' and 'financing green' are complementary processes, with a high degree of overlap. In this briefing we will focus on what 'greening finance' and 'financing green' mean specifically for issuers of debt securities.

Greening Finance

Are debt issuers indirectly impacted by requirements that apply directly to asset managers?

In our April briefing, we considered how the EU Taxonomy Regulation and the EU Sustainable Finance Disclosure Regulation are impacting asset managers and in our June briefing we looked at the FCA's consultation on introducing climate-related disclosures for asset managers and asset owners, including life insurers. We will return to the question in detail, including the impact of COP26, in later briefings in this series.

At the time of writing, these measures have not yet had a significant impact on the behaviour of debt issuers, but we are still at an early stage in the application of these measures. However, investors are starting to contact issuers to request certain taxonomy-related confirmations, particularly in relation to products that have been marketed as

green. The comfort that issuers should be prepared to give investors in this regard is still an open question, but it probably makes sense for any such comfort to be given to all investors within public periodic reporting (or publicly disclosed on issuance), rather than given on a bilateral basis. In any event it will be important for issuers to discuss expectations with their investors.

Will debt issuers be required to make periodic TCFD reporting?

We discussed last year the FCA's requirement for premium listed commercial companies to make climate-related disclosure on a comply or explain basis in their annual reports for financial periods beginning after 1 January 2021 based on the framework established by the Task Force on Climate-related Financial Disclosures (TCFD). In June, the FCA consulted on extending this obligation to commercial companies with standard segment listed shares. While many debt issuers are in practice caught by these requirements (by virtue of their equity listing) the FCA does not at this stage propose to require issuers with debt securities admitted to the UK Official List to make climate-related disclosure based on the TCFD framework simply by virtue of their debt listing. This is because those issuers include many overseas companies, special purpose vehicles, sovereign and municipal issuers and non-operating companies such as charitable trusts, for which the TCFD framework may not be appropriate or proportionate. The FCA has, however, asked market participants for their views of on whether to apply TCFD-aligned disclosure rules to issuers of debt securities and how best to do this.

It is worth remembering that the public debt capital markets universe extends to securities admitted to trading on a UK MTF (such as the London Stock Exchange's ISM), an EU regulated market or MTF (including the trading venues of Euronext Dublin, the Luxembourg Stock Exchange and Frankfurt's Freiverkehr) and other off-shore trading venues (such as those of Gibraltar and the Channel Islands). While some of these debt issuers may be subject to TCFD reporting as a result of either an equity listing or domestic corporate law requirements, or some of them may voluntarily opt into TCFD reporting, none of them will be subject to periodic TCFD reporting by virtue of their debt issuances. Any steps that the FCA take here would therefore be pioneering – and to the extent considered onerous, debt issuers could easily avoid them by moving to another trading venue. The FCA are certainly correct to point out the peculiarities and specificities of debt issuers and to ask this question in a nuanced way.

How should debt issuers disclose climate change and other ESG impacts in their offering documents and other marketing material for debt securities?

Whether and how to disclose climate change and other ESG issues in offering documents for debt securities is an open question and a developing area. Climate change and ESG disclosure tends to manifest itself in two different ways, firstly financial risk disclosure (which tends to be broken down further into transition risks, physical risks and sometimes also liability risks) and secondly as part of an issuer's business strategy, within which climate change and ESG issues can sometimes be presented as a commercial opportunity or a chance for an issuer to highlight a corporate purpose aligned with high ESG standards.

When deciding what and how to disclose, issuers need to consider both regulatory obligations and also market expectations. Issuers also need to tread a careful line between ensuring that the disclosure is specific to the debt securities, while also trying to ensure that it is consistent with their other public disclosure, such as annual reports. Issuers also need to remember that disclosure contained within any public offer or admission document (particularly one subject to the UK or EU prospectus regime) will attract common law and statutory heads of liability which are different from (and more extensive than) liability for their other public disclosure.

Regulatory disclosure obligations for offering and admission documents for issuers of debt securities tend to derive from the trading venue of those securities. Admission documents for debt securities admitted to the London Stock Exchange Main Market are therefore subject to the UK Prospectus Regulation, those admitted to an EU regulated market are subject to the EU Prospectus Regulation and those admitted to an MTF are subject to the rulebook of the relevant trading venue. It is worth recalling that it is possible (and for some products, such as convertible bonds, it is common) for debt securities to be issued without any formal offering document at all (relying on exemptions under the UK/EU Prospectus Regulation) which makes the question of climate change disclosure for those products entirely moot.

For prospectuses subject to the UK Prospectus Regulation, the FCA published a technical note in December 2020, reminding issuers of their obligations in relation to climate change and ESG

matters. While this guidance is not binding on prospectuses subject to the EU Prospectus Regulation, similar analysis applies. In this guidance the FCA points to parts of the UK Prospectus Regulation from which obligations to provide climate change and ESG disclosure can be inferred. But the UK Prospectus Regulation here is not as explicit as it might be, so it might therefore make sense for the FCA to clarify (likely now as part of the on-going reform of the UK prospectus regime) their specific expectations on climate change and ESG disclosure within UK prospectuses. For example, there could be a new specific requirement that issuers either disclose climate change financial risks or make a negative statement if there aren't any. There could also be a new specific requirement for an issuer to disclose its ESG strategy or make a negative statement if it does not have one. Beyond financial risks, issuers could also be required to disclose climate change and ESG risks relating to their activities which do not impact credit.

But policy-makers should also consider that regulation can be a blunt tool and there may be a market solution. In practice, issuers need to be mindful of market expectations, trade association recommendations and the practice of their peers. This is a developing area, with many issuers currently including detailed climate change and ESG disclosure in their debt offering documents, but others refraining from making any. This might suggest that there are some investors who accept that climate change and ESG issues do not represent a financial risk (or impact creditworthiness) for some issuers. It might also be the case that investors who are concerned about an issuer's broader ESG strategy are able to obtain sufficient information from an issuer's annual report (and therefore do not in fact need to rely on a debt offering document). Increasingly, it makes sense for issuers to discuss this question with arranging banks and investors and to anticipate questions related to climate change and ESG issues arising during the due diligence process.

For roadshow presentations in connection with a bond issuance, issuers should apply the same principles of disclosure to climate change and ESG information as they apply to other information. Broadly, information in the roadshow presentation should be consistent with information in any regulated offering or admission document (and for prospectuses under the EU/UK Prospectus Regulation, there are technical rules prescribing what consistency means). As a general rule, if information is not considered material for the purposes of a prospectus or admission particulars, it likely should not need to be in a roadshow presentation.

Financing Green

What labelled products are available?

In the labelled sustainable bond market, there are two broad categories of product, which are structurally distinct from each other:

(a) green, social and sustainability bonds (also called 'UoP bonds' or 'GSS bonds') which are the same as conventional bonds other than the issuer disclosing an intent to use the proceeds of the issuance to finance or refinance certain eligible green, social (or in the case of sustainability bonds, a combination of green and social) projects.

(b) sustainability-linked bonds (also called 'SLBs') for which the financial or structural characteristics vary (for example, a step-up in coupon), depending on whether the issuer achieves certain predefined sustainability-linked objectives.

These products are seen as complementary rather than in competition: each product has an attraction depending upon an issuer's circumstance or an investor's preference. More broadly, from the perspective of the general public, each product is capable of achieving a sustainable outcome. It is also possible to combine the features of these products into a single issuance. Within these categories, there is an additional sub-category of 'transition bonds', relating to issuer type rather than bond type. Within this transition bond sub-category are large greenhouse gas emitters which have tended to be excluded from conventional green bonds because of concerns with greenwashing: these issuers tend to make disclosure within the documentation for their labelled debt on the basis of ICMA's Climate Transition Finance Handbook.

The conventions underpinning labelled products currently derive from trade association recommendations, rather than any specific regulatory framework or indeed any case law. They reflect a highly innovative market and unsurprisingly their rapid development has thrown up some interesting disclosure and regulatory questions.

Using the ICMA labels and materials

For issuers, the starting point for sustainable bonds is the materials produced by the International Capital Markets Association ('ICMA'), which include principles and recommendations for both UoP green, social and sustainability bonds and also SLBs, a database of sustainable bonds that meet the requirements of an ICMA label and various other guidance.

The ICMA principles are updated regularly to respond to (or nudge) market developments. For example, in June the ICMA green bond principles were updated to give greater emphasis to two key recommendations: that green bond issuers produce a bond framework; and that they appoint an external review provider to assess the alignment of their green bond or framework with the four core components of ICMA's green bond principles (through a pre-issuance external review) and to verify the internal tracking and the allocation of funds from the proceeds to eligible projects (through periodic post-issuance external audits). The new edition also contains a recommendation for heightened transparency of issuer-level sustainability strategies and commitments.

While the ICMA principles do not have the force of law, their effect is highly persuasive in the sustainable bond market, with 97 per cent. of sustainable bonds issuance in 2020 based on the ICMA principles. From the perspective of an issuer, in addition to the green finance framework, careful thought needs to go into exactly how labelled bonds are documented, including the way that risks are disclosed in a public offering document and the level of detail given in relation to the projects (for UoP bonds) and it is also important to understand from investors their expectations (for example, frequency and level of KPI testing for SLBs).

The EU Green Bond Standard

It is widely expected that the European Commission will publish a legislative proposal for an EU Green Bond Standard ("EU GBS") shortly, which is likely to be based on the Usability Guide created by the EU Technical Expert Group on Sustainable Finance in March 2020. ICMA has been instrumental in shaping the EU GBS and therefore it feels very similar to the ICMA GBP. The overall aim of the EU GBS is to address several perceived barriers in the current market, including reducing uncertainty on what is green by linking it with the EU Taxonomy, standardising verification and reporting processes, and having an official standard to which certain (financial) incentives may eventually be attached.

Assuming that the EU GBS is based on the TEG usability guide:

- there will be new oversight and regulatory supervision of external review providers eventually conducted via a centralised system organised by the European Securities and Markets Authority (with a requirement that verifiers be based in the EU), with a market-based voluntary registration being put in place in the interim.
- the EU GBS will be entirely voluntary. So issuers can continue to issue green bonds (and market them as such) that do not comply with the EU GBS.
- To qualify for the EU GBS:
  - The 'Use of proceeds' would have to be linked to the EU Taxonomy, so that an EU GBS would have to (i) substantially contribute to one of the six environmental benefits set out in the EU Taxonomy (ii) do no significant harm to the other environmental benefits (iii) comply with minimal standards and (iv) comply with technical screening criteria.
  - The issuer must publish a green bond framework, based on a template.
  - The issuer must publish allocation and impact reporting, on an on-going basis, based on a template.
  - An external approved verifier must verify alignment of use of proceeds, green bond framework and actual allocation with the EU Taxonomy (and verification must be published)
- Because the EU GBS relate to 'use of proceeds', SLBs would be outside scope at this stage.
- There is no requirement for the issuer, projects being funded or investors to be established in the EU.

Practice to date is very varied: some issuers of green bonds do not mention the EU GBS in their disclosure, others refer to them in a generic way in their risk

factors and others disclose a loose intent to comply with their key principles. The formal legislative proposal is likely to increase levels of disclosure.

Market participants and policy-makers will no doubt look at this proposal carefully. Whether the European Commission's legislative proposal here will increase issuance (or result in a better allocation of capital to climate change mitigation and adaptation) is a more difficult question. Firstly, it is not clear if there really are in fact barriers in the current market that need to be addressed or whether there are any problems with green bonds that meet ICMA's GBPs that need to be solved via regulation. The success of the ICMA principles and the significantly increased volume of issuance in recent years suggests the opposite. One view is that market-led solutions are inherently more agile than regulation and therefore better able to innovate and respond to changed preferences.

For the UK, there is also the question over whether it makes sense to create a UK Green Bond Standard, with a similar set of issues arising. Policy-makers here should consider what specific problem any new regulation here would solve and whether it would in fact result in a better allocation of capital. A more effective solution might be for the FCA to endorse the ICMA GBP (and any other suitable market-led standard) more formally, rather than seek to replicate their work.

FCA discussion on issues related to green, social or sustainable debt instruments

As part of its June consultation paper, the FCA is seeking to generate discussion on issues related the labelled sustainable bond market, including both the link between a prospectus and 'use of proceeds' bond frameworks and also the role of verifiers and second party opinion (SPO) providers. In particular, the FCA questions whether they should require 'use of proceeds' bonds to contain a contractual obligation for issuers to use proceeds in a particular way, presumably together with a related event of default if an issuer breached this obligation. The FCA suggests that the current market convention under which a green use of proceeds bond simply represents an issuer's intent might represent a market failure. The FCA also questions whether they should mandate specific disclosure for labelled bonds under the UK Prospectus Regulation. They also raise the question of whether there is a need for a UK Green Bond Standard and whether second party opinion providers and other verifiers should fall within the FCA's regulatory perimeter (drawing inspiration from the European Commission's activities in this area).

While the FCA's discussion here is welcome, in our view the FCA should on balance refrain from requiring a contractual use of proceeds requirement for green bonds. This would be a significant departure from current practice and the ICMA principles. The FCA have also not made their case that existing practice does in fact represent a market failure: indeed, the ever-increasing volume of issuance and the innovative nature of this market suggest the opposite. While the FCA are correct to consider the consequences if an issuer did in fact use the proceeds of a green bond in a non-green way, the FCA have not cited any examples of this kind of green-washing occurring in the UK or European markets (making the harm at this stage entirely theoretical). It therefore seems inappropriate for the FCA to limit issuer and investor choice in this way, potentially resulting in a worse allocation of capital towards climate-change related or other ESG outcomes. It is also difficult to see how the FCA could in fact require a contractual use of proceeds requirement (given that green bond issuers could easily circumvent this by moving away from the UK Official List, following other market segments such as the convertible bond market and the high yield bond market which have in the past moved away from the UK Official List to avoid FCA requirements).

The FCA have not addressed the more difficult green-washing question, that on any given green bond issuance, it is difficult to be sure that the relevant projects do not simply reflect 'business as usual' of an issuer (not, therefore, in fact representing a genuinely more sustainable outcome). Careful study would be required to understand the extent of this problem (and it may be that reputational concerns of underwriting banks, coupled with intense scrutiny by investors, means that it is a relatively small one). The development of the UK Taxonomy and bringing second party opinion providers within the FCA's regulatory perimeter may also solve this question.

While there may be more merit to the suggestion that the UK Prospectus Regulation be modified to require specific use of proceeds disclosure for green bonds, careful thought would need to into any

legislative change. The UK Prospectus Regulation general duty of disclosure and the necessary information test arguably already require a high degree of disclosure. It is also worth noting that current market practice is for issuers to refer to their green bond frameworks in their prospectuses without specifically incorporating them by reference. The exact amount of disclosure here varies, but more recently practice has been for a short, high-level paragraph in the use of proceeds section, for example referencing the ICMA Green Bond Principles or disclosing that a second party opinion has been obtained. This is partly because this disclosure may be difficult to diligence, may change over time and is not disclosure which strictly goes to the credit.

What are trading venues doing?

The London Stock Exchange, Euronext Dublin and the Luxembourg Stock Exchange have established dedicated green and other ESG bond capabilities. The London Stock Exchange's Sustainable Bond Market (SBM) has distinct platforms for different classifications of sustainable bonds with admission to the SBM being conditional upon submission by the issuer of a SBM declaration and application form including disclosure of mandatory sustainability related documents and an acknowledgement of on-going reporting obligations.

Other regulatory issues

In addition to the prospectus regime, the exact way that labelled bonds should fit into other regulatory frameworks is still being worked through. Policy-makers here need to balance the aim of incentivising sustainable issuance without cutting across investor protection mechanisms or financial stability. For example, in June the EBA published guidance to the effect that EU banks can issue 'use of proceeds' subordinated debt instruments that qualify as regulatory capital for the purposes of the EU CRR, but for the present it seems that sustainability-linked bonds will not qualify. It remains to be seen what position the PRA will take for UK banks and how insurers will be impacted both in the EU and in the UK. Both the Bank of England and the European Central Bank are taking steps to green their respective eligible collateral requirements and corporate bond purchase programmes, but in the case of the ECB for example, only SLBs with KPIs linked to either (i) one or more of the environmental objectives set out in the EU Taxonomy Regulation or (ii) one or more of the United Nations Sustainable Development Goals relating to climate change or environmental degradation) are eligible, whereas KPIs linked to other targets (for example, gender diversity) are excluded. Sustainability-linked bonds are also likely to fall within the current scope of the EU and UK PRIIPs Regulations, which may disincentivise retail issuance of these products.

Conclusion

Each year that passes is another record year for labelled bond issuance and also another year closer to 2050, the year that governments have committed to reach net zero greenhouse gas emissions. It is therefore not surprising that both regulation and market practice have continued to evolve very rapidly over the last year and there is no indication that the pace of change will slow down. Questions around how climate change and other ESG issues impact the debt capital markets are now here to stay.

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