Can PF lenders truly influence ESG compliance?

Agnes Mazurek

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Guest writer: Agnes Mazurek, senior consultant, private and infrastructure debt

I recall the times, less than a decade ago, when project sponsors (who hold the equity interests in the borrower), were pushing back on ongoing undertakings re Equator Principles compliance in the finance documentation of greenfield projects.

The argument was that they had no control whatsoever on an externally prescribed set of principles. Lenders knew they had no chance of getting this accepted, and nonetheless put it on the list of negotiation points, so as to trade it off for another, much more valuable documentation point. We have come a long way since then, although the stakeholders on sponsor and lender side, and often the people, remain the same (Mazurek, pictured right).

The truth is, project finance lenders have been looking at investments through an ESG lens for a long time, by refraining from lending to some types of industry or being mindful of the reputational risk attached to others.

In other words, lenders have been looking at sustainability in risk terms, rather than with a view to achieve a positive impact. Which leads us to consider 2 of the fundamental differences between debt and equity positions in a company or a borrower: the benefit of upsides/increase in value and the type of controls that can be imposed. An equity shareholder will benefit from an increase in the company's value, the lender will not. An equity shareholder has the ability to give the company a direction, the lender can only incentivise through various levers. And anyone familiar with project finance documentation knows these many pages of information undertakings, representations, warranties carry the potential for multiple incentives towards ESG compliance.

So what is it we are missing?

Let's have a look at the less documentation intensive, arguably less sophisticated corporate issuer world. The volume of ESG-linked bond issuance has surged in 2020, exploding particularly in Europe and in Asia, with a yearly growth of 144% and 354% vs. 2020, respectively (Bloomberg). Social- and sustainability-linked issuance outpaced issues of green bonds, with combined volume more than doubling last year compared with 2020.

The same trend is observable in the loan market. While sustainability-linked loans (SLLs) are a small sub-set of sustainable debt, they have grown from virtually nothing in 2017 to $120 billion in 2020.

This shows how fast the market is evolving amid the growing political, regulatory, investor and consumer pressure for companies to mitigate ESG-related risks and reduce ESG impacts beyond those related to climate or environment.

Infrastructure in its wider sense (meaning project finance) has a much more substantial climate footprint than other sectors, as shown by the MSCI ACWI index comparing global equities to listed infrastructure equities. Moody's (2020) found that project finance bank loans for green projects exhibit a lower default risk than non-green projects. It would therefore appear logical that project finance borrowers accept the link between sustainability and return considerations.

For project finance, the takeaway is that more and more corporate and private credit issuers have been willing to tie ESG compliance to the only incentive that really matters: pricing. And this is the real game changer. Whether project finance, an industry that has never been characterised by speed of change, will catch up with private equity, direct lending and other alternative asset classes, and the corporate world in general, remains to be seen.