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Implications of sustainable finance for the loan market

Sustainable Finance and Responsible Investment

April 2021

This briefing note reflects the content presented in a webinar by Chinyelu Oranefo recorded in March 2021 as part of the Loan Market Associations ("LMA") Talking Taxonomies series. This is the third note in our sustainable finance April update series.

Direction of Travel

A combination of the implementation of the EU's Disclosure Regulations and the UK's commitment to implement the TCFD means that insurers, pension firms, financial institutions and many other firms key to the financial ecosystem within the EU and the UK will start making increased ESG related disclosures during the next 24 months by reference to either the EU or possibly the UK Taxonomy.

Why should the Loan Market Care?

The EU (or any other) taxonomy and disclosure regulations seem quite far removed from every day banking transactions so I thought it might be helpful to round up by discussing a few reasons why I think anyone that is part of the loan community should be interested in these initiatives.

Firstly, a Taxonomy can be used as the foundation for sustainability-themed products such as bonds and funds and one of its primary objectives is to create a standard that can not be called into question as "greenwashing". As such we can expect serious discussions about each Taxonomy's relevance to the market driven and voluntary "green bond" or "green loan" principles.

Aside from that potential direct effect on green and sustainability linked loans, there are a number of categories of what we'd call "indirect effects" that the EU Taxonomy and disclosure regulations will have on the market. These arise because asset and fund managers are players (directly or indirectly) in the debt financing ecosystem. Their need to comply with the taxonomy will have an impact on the nature and structure of their investments and the financing of underlying assets, particularly where there is already a huge demand for ESG products which far exceeds supply. In this sense there will need to be a marrying up of front office activities and back office reporting requirements. Another indirect effect the Taxonomy has is on asset classes and their desirability. If investors and bond markets begin to move towards taxonomy aligned activities and away from non-aligned activities, there is potential for an interesting sustainability-linked refinancing risk emerging.

Our firm's experience is that despite the fact that green loans got a head start, sustainability linked loan products are much more popular. Why is this? Probably because the product seems to reflect the fact that most enterprises are not "green" overall (although they may have particular assets or projects which would qualify as being so). Most companies are on a journey towards sustainability and need to know what we mean when we say "green" or "olive" or "brown". Obviously the EU, UK or any other taxonomy will play a key role in setting these parameters.

This is why we need solid "transition" products and I would argue that the next developments in the loan market industry, in the absence of EU or UK legal prescription, will include increasingly more robust structures for transition finance.

Lastly despite Brexit, the UK market is still likely to be strongly influenced by the EU sustainable finance regulations either because the firms have a presence in the EU, they sell products into or have investors within the EU or because these regulations become market standard.

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