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Lenders must rise to the ESG challenge

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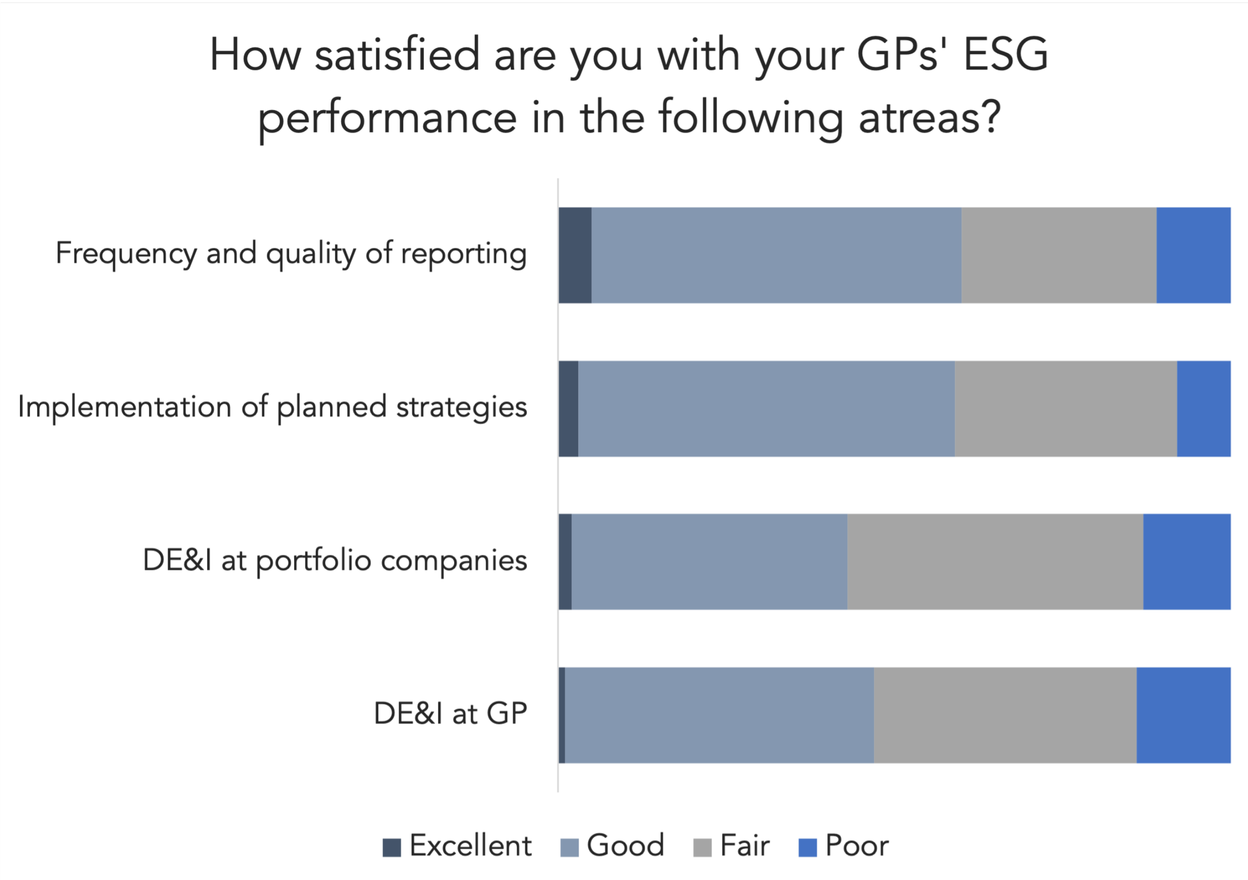

From being seen as non-participants, debt providers are these days seen as having a crucial role to play in driving responsible borrower behaviour.

Long gone are the days when lenders were considered backseat drivers, with little to add to the debate on how borrowers should be engaging with environmental, social and governance issues. These days, as one market source recently commented to *PDI*, “the role lenders have in driving ESG as stakeholders is absolutely huge”.

The same source said it’s worth considering how, when it comes to mortgages, individuals can get treated preferentially for having an energy efficient home. This kind of thinking, he said, would come much more into mainstream lending and become a key consideration within credit and investment committee processes. It could even be a ‘make or break’ issue: ‘do we even consider providing finance to companies who don’t have ESG high enough on their agenda?’

Thus far, ESG has mainly been viewed through the lens of pricing and terms in the private debt market, especially by way of the margin ratchet, whereby interest rates charged to the borrower can move up or down depending on how well (or badly) they perform in response to ESG-related KPIs. There has been some criticism of these KPIs, with some feeling that the bar has been set too low for achievements to be meaningful – both in terms of how difficult they are to accomplish and also in terms of the level of reward and punishment.

There's undeniably plenty of innovation going on. We heard of one sustainability-linked loan towards the end of last year where – to avoid criticism that lenders benefitted financially from their borrowers' failure to meet ESG targets – "punishment money" went into a pot to be applied to charitable causes. Interestingly though, this was a bank lending group – ESG is one area where banks are perceived to be ahead of the game.

As the chart above shows, investors are far from convinced that fund managers have got everything right on ESG. They have come a long way on the journey from passive to active, but there are still lessons to be learned.

(Past performance is no guarantee of future results.)