ESG in 2021 So Far: An Update (Part I of III)

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The rapidly growing focus on environmental, social and governance (ESG) matters that marked 2020 continued to shape events for companies operating or based in the U.K. and Europe in 2021. Discussions of ESG are occurring at all levels, from the boardroom to investors to employees, and governments, regulators and companies are all being encouraged to take these matters into consideration. In our 1 February 2021 article ("ESG: Key Trends in 2020 and Expectations for 2021"), we set out what we thought would be the key ESG trends to watch this year. In this article, we take stock of those predictions, discuss new issues that have emerged over the year and identify the trends we think will be prominent during the remainder of 2021.

Looking Back: Correct Predictions

A number of our key expectations at the outset of the year have been borne out.

ESG Funds[1]

In the first quarter of 2021, inflows into European "sustainable" funds totalled to €120 billion, 18% higher than the first quarter of 2020, according to Morningstar, comprising slightly more than half of all fund inflows for the first time. Of that, €36.5 billion went to passive index and exchange-traded funds. Despite the latter growth, there is concern that passive funds will struggle to match the service provided by active managers due to (i) the subjectivity involved in determining appropriate ESG credentials until there is a standardisation of ESG data and reporting and (ii) the ease with which active managers can react to controversy compared to passive ETFs, which must wait for an index committee review before changing investments.

In the U.K., the Financial Conduct Authority (FCA) issued a warning in July to all ESG funds, both passive and active, of the need to improve, in the form of a "Dear Chair" letter setting out guiding principles for the products. Although the FCA states that it welcomes innovations in the market, the rapid pace of change has raised some issues. In particular, the FCA is concerned by the number of poor-quality fund applications it has seen and the impact this may have on consumers.

The FCA's guidelines are based on three principles:

i. the design of the fund and disclosure of its ESG investment strategy should be fairly reflected in the fund's documentation;
ii. the implementation of the fund's ESG investment strategy should be appropriately resourced and consistent with its disclosed objectives; and
iii. ESG-related information disclosed by the fund should be easily available and comprehensible for investors to enable them to make investment decisions.

It will be of particular interest over the next few months to see the impact, if any, that these new guidelines have on the ESG fund application process.

***Sustainable Finance Market*[2]**

As we predicted in February 2021, the market for green bonds has boomed. According to a report by the Climate Bond Initiative, global issuance of green bonds is on track to reach between $400 billion and $500 billion in 2021, nearly double the record high of $270 billion in 2020, with $54 billion invested in ESG bond funds in the first five months of 2021 alone.

Moreover, the sustainable finance market has continued to expand beyond green bonds. Although non-investment-grade sustainability-linked notes only appeared for the first time in March 2021, they have proved popular in Europe, with €3.44 billion worth issued by June. Nearly two-thirds (65%) of widely syndicated leveraged loans in the European market contained an ESG pricing ratchet in Q2 2021, adjusting the margin on the debt based on ESG-related performance. This is a very significant development, given that ESG pricing ratchets were largely an investment grade phenomenon in 2020.

The growth of this market reflects both investors' increased focus on ESG and the appeal of lower borrowing costs that green debt offers governments and companies. This so-called "greenium" can be difficult to measure given the rarity of concurrent issuances of green and conventional instruments. However, there is a direct comparison available in Germany, where the benchmark green government bond has a yield around 0.05% points lower than its conventional "twin". The pricing of the so-called green Bund is the same as the standard bond, yet investors have accepted the lower return on the former. This has led to concerns that the market could be a bubble waiting to burst.

There are also concerns about "greenwashing" as the market moves beyond investment grade products. For instance, despite requirements that green instruments contain specific terms on the use of proceeds, many of those instruments state that the issuer may not be able to use the proceeds for the intended purposes. That gives borrowers an out and calls into question the validity of the “green” label. As a result, the International Capital Market Association has updated its green and social bond principles, which are the global standard for a $1.6 trillion market, putting a greater focus on transparency. The principles recommend a framework for the instruments, external review of the key performance indicators (KPIs) used to measure sustainability achievements and more information at issuer-level in order to build confidence among investors.

The EU also intends to introduce more stringent rules requiring impact reporting and external reviews in order for a product to be labelled as a “European Green Bond”. Issuers will need to make extra efforts to qualify for that designation, but the intention is to achieve cheaper borrowing costs because investors appear willing to pay a premium for ethical quality. (We discuss greenwashing further in the final section below.)

***ESG Activism*[3]**

As predicted, activists of various sorts pressed companies aggressively on ESG issues this year. Through 9 June 2021, globally there had been 169 ESG shareholder proposals in the 2021 annual general meeting season, which have garnered average support of almost 34% of shares voted, primarily supported by fund managers that are becoming increasingly vocal about their support for ESG proposals. In comparison, only 171 resolutions were filed in the whole of 2020, with support averaging less than 29% of shares voted.

ESG challenges to “Big Oil” captured the most attention. Most notably, activist hedge fund Engine No. 1 elected three directors to the board of Exxon Mobil and sponsored two shareholder proposals that won majority support, all against the board’s recommendation. One proposal called for an annual report on lobbying, while the second requests a report describing how the company’s lobbying efforts align with the goal of limiting global warming.[4]

Meanwhile, a district court in the Hague ruled in favour of climate campaigners who challenged Royal Dutch Shell’s emissions policy. The decision requires the company to take greater action in order to meet the Paris Climate Goals. In the U.K., BP successfully defended a call for greater action on climate change, but the resolution received 21% of the votes, meaning the company will have to return to investors to discuss their concerns, in accordance with the U.K. Corporate Governance Code.

Some commentators have argued that Engine No. 1 only succeeded due to Exxon’s ESG and financial performance, making the company a traditional activist target. Others have emphasised that the shareholder pressure may not reduce the use of oil and gas or emissions from their production; that it may simply result in energy assets changing hands. Even if listed companies make divestments in order to meet carbon emissions targets, there remain plenty of private and stateowned buyers willing to purchase these assets. As a result, the impact of such activism is perhaps overstated. Currently, only 12% of oil and gas reserves are held by public companies.

The past six months signal a shift in favour of ESG activism and Big Oil is unlikely to be the only focus as other investors and campaigners push on ESG issues. Several companies have recently received requests to disclose the company's race and gender diversity figures and activists requested information about fashion house Hugo Boss's supply chains.

This is *Part I* of a three-part post. *Part II* will continue to examine previous ESG predictions for companies based in the U.K. and Europe in 2021. *Part III* will discuss new areas of interest in the ESG field and make new predictions.

Footnotes

[1] *Financial Times*, "Rise of ESG renews debate over whether passive funds can deliver" (25 June 2021); FT Adviser, "FCA warns on 'poor-quality' ESG fund applications" (19 July 2021); Financial Conduct Authority, "Authorised ESG & Sustainable Investment Funds: improving quality and clarity" (19 July 2021)

[2] *Financial Times*, "Investors pile $54 billion in to ESG bond funds in fiery start to 2021" (25 June 2021); Forbes, "How green are green bonds" (2 June 2021); *Climate Bond Initiative* "Sovereign, Green, Social, and Sustainability Bond Survey: The ultimate power to transform the market" (24 January 2021); *LCD*, "ESG goes mainstream across global leveraged finance markets in 2021" (25 June 2021); *Covenant Review*, "ESG Trendlines in European Leveraged Loans — Q2 2021" (14 July 2021); *Financial Times*, "Borrowers tap hot ESG demand to sell green bonds at a premium" (9 April 2021); ICMA, "*Green & Social Bond Principles 2021 edition issued*" (10 June 2021); Bloomberg, "EU's gold standard in green will command biggest debt premiums" (10 July 2021); *Corporate Counsel*, "Sustainable Finance: Green Bonds Shine — But It's Not Easy Being Green" (10 June 2021).

[3] *Financial Times*, "BP dodges new climate target calls as activist pressure grows" (12 May 2021); Bloomberg, "The world's biggest investors get louder about ESG" (9 June 2021); Bloomberg, "Shareholder activism campaigns rebound out of pandemic" (21 June 2021); *Financial Times*, "A $140 billion asset sale: the investors cashing in on Big Oil's push to net zero" (6 July 2021); Bloomberg, "After Exxon, activism's next shareholder victory could be the S in ESG" (15 June 2021).

[4] See "What the Exxon Mobil Shareholder Votes Mean" in Skadden's publication *The Informed Board* (16 June 2021).

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