Chapman and Cutler LLP

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Screening for ESG Criteria in Lending and Investment Transactions

Last month the United Nations' Intergovernmental Panel on Climate Change (IPCC) issued a dire report in which the IPCC concluded that sustained and large-scale reductions of greenhouse gas emissions are imminently needed to reach the Paris Agreement's goal of limiting global warming to 1.5 degrees Celsius as compared to pre-industrial levels. The report warns that, without such reductions, the planet will face increasingly devastating changes to the global climate system, including more frequent and severe weather events.

Such reports, coupled with recent severe weather events and the effects of COVID-19, continue to increase awareness of Environmental, Social and Governance (ESG) criteria amongst investors and lenders. Lenders and investors are taking different approaches to building ESG portfolios based on the entity's own preferences and values. However, one widely used tool involves screening of select assets or transactions that align with those values. Screening describes the process of using a set of filters to determine which companies, sectors, or activities are eligible to be included in an ESG portfolio.

According to the Principles for Responsible Investment's (PRI's) guidelines, screens can be negative, normative, or positive (or a combination of the three). A negative screen is used to avoid the worst performers by excluding certain sectors or activities either absolutely or for poor performance relative to their industry peers. A normative approach screens loans or investments against minimum established standards of business practice. Positive screening, on the other hand, involves affirmatively selecting sectors, issues, or projects based on their positive ESG benefits or for their performance relative to industry peers.

Several useful tools are available to assist investors and lenders in screening for ESG transactions. For example, the Loan Syndications and Trading Association (LSTA) has developed a *ESG Diligence Questionnaire for Borrowers* and a similar one for managers. The LSTA's borrower questionnaire addresses all three ESG criteria and incorporates negative, positive, and (to some degree) normative screening tools into its framework. The questionnaire focuses on ESG governance, framework, factors, and revenue, as summarized below:

- *ESG Governance* – Gathers information on the company's ESG policies, reporting, oversight, and compensation structure (*i.e.*, the level of management involved in ESG and whether ESG performance is integrated into compensation or performance evaluations).

- *ESG Framework* – Incorporates a normative approach to ESG screening by eliciting information on whether a company adheres to third party ESG frameworks and structures, such as the Carbon Disclosure Project (CDP), the Sustainability Accounting Standards Board (SASB), the UN Global Compact Principles, the UN Sustainable Development Goals, and the Ceres Roadmap for Sustainability. Requests copies of any available reports and/or scores associated with these structures.

- *ESG Factors* – Requests information on both direct and indirect greenhouse gas emissions, a strategy for reducing greenhouse gas emissions, sustainability-related issues facing the company (including for all three ESG categories), and the company's approach to board, management, and workforce composition. This portion of the questionnaire allows room for companies to provide information on human resource and environmental issues that the company has likely already published either internally or publicly.

- *Revenue* – Incorporates negative screening by requesting information on what percentage of revenue a company derives from a list of specified activities, such as adult entertainment, oil and gas, cannabis, coal-fired electric generation, weapons, gambling, payday lending, and tobacco. Each lender or investor should consider tailoring this list to meet its own internal criteria.

Screening tools such as the questionnaire published by the LSTA are useful for investors and lenders alike in determining whether potential loans or investments may meet internal ESG criteria. Any such questionnaire, however, should be flexible and tailored both to meet the goals of the user and to address

the most important issues confronting the enterprise being screened. Each industry faces unique ESG challenges and concerns. For example, from an environmental perspective, certain industries may not be large emitters of greenhouse gas emissions but water usage or sustainable packaging may be a crucial consideration facing the industry. Screening such a company regarding only climate change considerations would miss the mark. ESG diligence in general is still in its early stages and there is no one established protocol or approach for conducting it. The ESG issues that companies face will continue to evolve as must the tools used to measure and evaluate ESG performance.

For More Information

Please contact Kristin Parker, the Chapman attorney with whom you regularly work, or visit our ESG Counsel and Sustainable Finance resources at chapman.com.

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