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Blossoming of ESG in the Nordic leveraged finance market?

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Borrowers' performance within environmental, social and governance (ESG) is becoming increasingly important for investors in deciding where to put their money. Whilst ESG has been prevalent in investment grade finance for some years, the Nordic leveraged finance market has lagged behind in this trend. However, in recent months, we have seen a push by lenders for sustainability terms to be adopted in leveraged loan documents. In this brief, we explore on ESG and the key considerations relevant for ESG in the Nordic leveraged finance market.

What is an ESG-linked loan?

A loan is considered 'ESG-linked', if it includes terms which incentivise the borrower to improve its performance against certain ESG criteria agreed with the lender. ESG-linked loans differ from "green-loans" which require that the loan proceeds be used for certain pre-defined green purposes, such as reducing carbon emissions. ESG-linked loans, on the contrary, are sector agnostic and are usually taken on to finance asset or activities unrelated to sustainability[1].

Why is ESG attractive to mid-market participants?

There is an array of reasons why the loan parties are keen to label their lending relationship as ESG-linked, but currently, risk management, fund raising and reputation appear to be the key drivers amongst the market participants involved.

For sponsors, monitoring and addressing ESG risks on an ongoing basis has become an important factor in ascertaining a borrower's risk profile and in prioritizing capital allocation. Moreover, sponsors are actively showcasing ESG credentials as part of their fundraising and investment activities. A survey published on 13 January 2021 revealed that 89 % of the 452 funds surveyed had an ESG policy in place at the fund level, and approximately 80 % had introduced programmes to improve the performance of portfolio companies[2]. Accordingly, when negotiating ESG requirements in the context of portfolio financing, sponsors are usually conscious about ensuring that each ESG scheme interacts with their overall CSR strategy or sustainability programme at the fund level.

Over the last six months, we have seen arrangers pick up ESG as a material discussion point with their Nordic leveraged loan borrowers. This trend has been led by private debt funds who have committed to sustainability targets vis-à-vis limited partners during fund raising and which operate in markets, where ESG is more commonplace. This influx of sustainability features into leveraged deals appears to have piqued the interest of banks and other arrangers in the Nordic leveraged finance market, looking to take on prestigious mandates as 'sustainability coordinator', bolster CSR narratives and sell down participations in a secondary market with an increasing appetite for sustainable investments.

It is yet to be seen, whether regulators will adopt laws which will provide tangible incentives for sustainable finance in the leveraged finance market. In March 2018, the European Commission published its Action plan on Financing Sustainable Growth, setting an EU strategy on sustainable finance and a roadmap for future work across the financial system. Following publication of this plan, the EBA published its own work plan which includes considerations on how ESG can be incorporated into the regulatory and supervisory framework of EU credit institutions.

What are the key documentary ESG features?

In terms of documentation, there is no established market standard for linking a loan to ESG, and thus, little consistency in approach applies across loan documents. On 20 March 2019, a working group lead by the Loan Market Association (LMA) published the "Sustainability-Linked Loan Principles' (SLPs), which include a set of guiding principles for sustainability linked loans weighed against environmental factors. Although Nordic loan participants generally look to the SLPs when documenting sustainable loans, ESG discussions predominantly revolve around the borrower's specific business context and setting targets which specifically address the risks/opportunities associated therewith. For example, whilst reduction of workplace injuries may be particularly relevant for one borrower, gender diversity (which is not addressed in the SLPs) may be particularly relevant for another borrower.

Below, we have set out the documentary features, which are commonly included in an ESG-linked leveraged loan:

Pricing: The core feature of an ESG-linked loan is a sustainability linked pricing ratchet. I.e. in return for the borrower satisfying certain predetermined sustainability targets (see further below), the borrower gets a discount on the margin. On the contrary, if the borrower fails to perform against the sustainability targets, a margin premium kicks in. In the current market, sustainabilitybased margin adjustments are still fractional, ranging typically between 15 - 35 basis points[3]. However, adjustments are expected to increase in significance over time, with some participants even predicting that

[1] See, for example, the EU Green Bond Standards. https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-green-bond-standard_en.pdf. [2] Coller Capital. https://www.collercapital.com/coller-capital-esg-report-and-perspectives. [3] Loan Market Association: "Nordic loan market - Legal hot topics", 1 February 2021

failure to comply with agreed targets may result in an 'ESG default' (see further below).

ESG targets: A sustainability linked pricing ratchet relies on the loan parties setting targets for the borrower's ESG performance over time. In practice, ESG performance is measured either by reference to an overall ESG score or certain specific key performance indicators (KPIs). Lenders in the Nordic market generally rely on KPIs to measure ESG performance with the number and type varying depending on the nature of the group's underlying business. Chart 1 below includes an overview of the KPIs proposed by LMA in the SLPs and Chart 2 below includes certain other non-SLP KPIs which are frequently used in the Danish market. Sustainability targets (whether in the form of an ESG score or KPIs) will usually be tested annually with reference to the borrower's performance as at the last date of the previous year. Usually, an amendment to agreed ESG targets will be subject to a majority lender consent.

Reporting: Reporting to lenders on the borrower's performance against ESG targets will usually take the form of an annual 'sustainability compliance certificate' prepared by the borrower itself. The certificate will include the target of each KPI for the relevant testing period together with the borrower's actual performance. Usually, no validation of the borrower's self-reporting is required, but this is an area characterised by rapid development is expected with many third-party rating agencies entering the scene.

ESG coordinator: Larger borrowers looking to take on an ESG-linked loan may entrust one of its lenders with the role of "sustainability/ESG coordinator'. A sustainability coordinator is responsible for assisting the borrower in determining and measuring sustainability targets and managing the flow of communication/information between the borrower and the other lenders for purposes of ESG matters.

Consequence of breach: The consequence of failing to satisfy an ESG target or to deliver a timely ESG compliance certificate is a margin premium rather than an event of default.

Use of proceeds from ESG driven pricing changes: In some cases, the loan parties may agree that some or all of the proceeds from ESG adjustments to the loan pricing shall be used for certain designated purposes, e.g. charities.

Chart 1 | SLP KPIs and their popularity

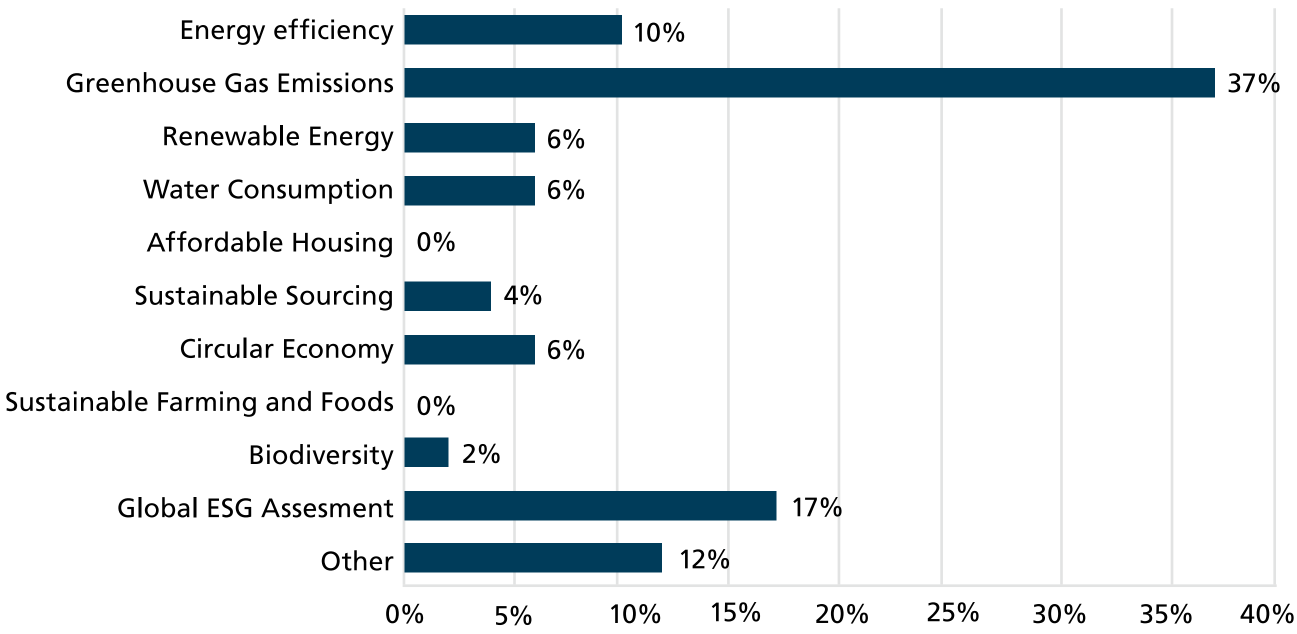

Chart 2 | Non-SLP KPIs frequently seen in the Nordic market

- Percentage of women in senior management positions
- Use of plastic
- Carbohydrate and calories content
- Incident rates
- Waste reduction/management

Questions?

If you have any questions concerning this brief, please feel free to contact us.

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