Environmental, Social and Governance Alert

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How ESG is Impacting the European Leveraged Finance Markets

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As we noted here, environmental, social and governance (ESG) factors are becoming increasingly relevant across the finance markets and have impacted a range of financial instruments. The European leveraged finance market has traditionally been immune to outside influence, yet as investors, banks, sponsors and corporates are themselves becoming increasingly aware of and impacted by ESG, so the leveraged markets are having to respond and adapt.

With the backdrop of the European Green Deal and related sustainable finance initiatives, participants in the leveraged finance markets have identified opportunities to incorporate ESG into loan and high-yield documentation. By way of example:

- Due diligence: at the outset, an assessment of ESG policies and procedures as part of early-stage disclosure and due diligence exercises, discussions with management and road-show presentations.
- Information reporting: issuer/borrower-specific reporting as to compliance with ESG policies and procedures, together with potentially broader reporting requirements tied to applicable legislation or bespoke key performance indicators (KPIs).
- Pricing rewards: margin ratchet decreases for favourable achievements and/or compliance with predetermined ESG metrics or KPIs coupled, in some instances, with corresponding margin increases for noncompliance.

The features described above are not necessarily innovative as such when compared to traditional “green” or “sustainability-linked” products—described in more detail here—but they do add an interesting and novel twist to the leveraged finance market, a world often historically caricatured as being solely driven by hard-nosed economic return at the expense of all else.

There are clearly challenges with the incorporation of ESG features, most notably in striking the appropriate balance between meaningful and measurable accountability. From an issuer/borrower perspective, it is important to avoid hair triggers, yet from the investor/lender viewpoint, any ESG metrics need to be sufficiently robust, especially if those market participants are themselves reporting to their own investors or complying with regulatory obligations. Finally, it is important to ensure that any economic upside as a result of ESG compliance does not result in so-called “greenwashing,” conveying a false impression as to how an issuer’s/borrower’s performance is sustainable or environmentally sound. It is expected that investor demand for independent reporting and consistent application of ESG standards and frameworks, whether by way of rating agencies or otherwise, will only increase.

Despite the many open questions and avenues to be explored, given its wide sphere of influence and the sheer volume of market participants, it is refreshing that the leveraged finance market is embracing ESG.

The Akin Gump team will be working with industry players going forward to track ESG within the leveraged markets and are available to discuss.

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