European Leveraged Finance Association

PRESS RELEASE

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Concerns emerging over "greeniums" in high yield bonds as credit investors split on justification – ELFA research

- **Half of investors believe greeniums are justified**
- **Industry standard for coupon step-ups not high enough**
- **External KPI verification desired across bonds and loans pre-issuance and audited annually**

London, 7 July 2021: Views among investors are mixed on whether "greeniums" (a premium for a green bond or sustainability-linked bond) are justified and investor concern is emerging over an issuer's ability to "game" greeniums, according to a survey by the European Leveraged Finance Association (ELFA).

The survey of over 170 credit investors in Europe sought investor views on the emergence of ESG provisions in high yield bonds and leveraged loans, with results published in a report today outlining terms and emerging trends for ESG provisions across these markets. The report also outlines key points included in guidance on sustainability-linked leveraged loans which is under development by the ELFA and the Loan Market Association.

Gaming greeniums

The research found that nine in 10 credit investors in Europe (90%) own bonds or loans that incorporate ESG provisions. Despite the vast majority of investors owning these instruments, investors have diverging views over whether greeniums are justified in Sustainability Linked Bonds (SLBs) and Green/Social/Sustainable Bonds (GSS Bonds). Just over half believe that they are justified provided the structure and targets are robust and credible (SLBs: 51%; GSS: 55%).

Responses suggest concern among investors that some companies may be able to reap the benefit of greenium-style interest savings whilst avoiding meeting, or even testing, Key Performance Indicator (KPI) targets by issuing high yield bonds that are callable before the KPI target date. When asked what the cost of calling the bond should be if the non-call period ends before KPIs are to be tested, half of respondents (50%) said this should be 50% plus the coupon step-up. Over a third (36%) chose a call price of either 75% or 100% of the coupon.

Despite these concerns, high yield investors do appreciate that KPI testing will be case dependent. Over a third of investors (37%) think that two to five years is an appropriate timeframe for a borrower to test KPIs, with a quarter (25%) choosing less than two years, which would almost certainly fall within the non-call period. A further 30% think there should be no absolute timeframe as it will be both bond tenor and KPI dependent.

Almost all leveraged loan investors (96%) agree that all relevant KPI information should be determined and disclosed before they commit to a deal. In addition, nine in 10 respondents (90%) said that it would not be appropriate to flex ESG KPIs in the event a deal has strong demand.

Coupons need to step-up

The current market standard for a coupon step-up is 25 basis points (bps), with five out of the six SLB deals in the European high yield universe setting the coupon step-up at this level. Three quarters (75%) of investors surveyed do not believe 25bps is high enough. Two in five (39%) think a coupon step-up of between 25-50bps is appropriate, while a further 30% think it should be larger than 50bps or equivalent to 20-50% of the final coupon.

Sabrina Fox, Chief Executive Officer, European Leveraged Finance Association, commented:
"The market for SLBs and GSS Bonds is still in its infancy, with financial conditions and KPIs continuing to develop. We conducted this research to better understand these emerging trends and issues, as it is important that any potential concerns among investors are tackled at this early stage to ensure the European leveraged finance market is both resilient and transparent. An issuer's proposals must be robust and ambitious enough to guarantee the integrity of the product and limit greenwashing risks."

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External verification desired across bonds and loans

Almost three quarters (72%) of high yield investors think that external verification on KPI selection and targets should be required pre-issuance, whilst 26% would go without so long as there is strong disclosure on the internal expertise and methodologies used to arrive at the KPI target. Almost all respondents (96%) answered that high yield issuers should report their progress on KPI targets at least annually, with some commenting that reporting should be made with the same frequency as a borrower's financial reporting.

For leveraged loans, 71% of investors agree that a third party ESG coordination agent or rating agent should initially be involved in KPI setting. A third of investors (32%) think that their input should be incorporated into KPIs and a further 37% say investors should at a minimum be involved by way of a call with the borrower's head of ESG or sustainability coordinator. Almost nine in 10 loan investors (87%) want KPIs audited by external parties annually. The majority (82%) of respondents also think that a margin step-up should be applied if a company does not provide an ESG or sustainability report, or third-party confirmation.

Sabrina Fox added:
"Our research highlights that robust reporting and external verification are important to investors. Regularity of reporting may be a cause for concern for issuers, with many currently reporting ESG information only once a year, or even less given the time-consuming nature of ESG-related KPI data collection. Most issuers will report annually as part of their annual sustainability report. However, we note there is an absence of reporting covenants tied to Sustainability Performance Targets, meaning no contractual obligation to report on these. Reporting is key for investors to be able to hold issuers to account and to combat risks of greenwashing."

With ESG provisions appearing more frequently in fixed income instruments, 96% of survey respondents agree that a standardised questionnaire would support discussions with borrowers about provisions in green, sustainability and ESG-linked products. In response to this, and ongoing engagement with members and the wider industry, the ELFA is producing a resource to support strong engagement on ESG provisions in both high yield bonds and leveraged loans.

The ELFA's report, The Emergence of ESG Provisions in Leveraged Finance Transactions, outlines further details of the research and an overview of key terms and emerging trends, and is available on its website here.

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Notes to Editors

ELFA survey of 178 high yield and leveraged loan investors in Europe; conducted in May 2021. 85% of respondents were asset allocators (portfolio managers / research analysts).

About the ELFA
The ELFA is a trade association comprised of European leveraged finance investors from over 45 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information, please visit the ELFA website: www.elfainvestors.com.