European Leveraged Finance Association

INSIGHTS

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ESG Disclosure Initiative – Key Themes from ELFA's ESG Workshop for Company Advisers and Second Edition of the Guide

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Executive Summary

- In January 2022, ELFA together with the LMA co-hosted an ESG Disclosure Workshop for Company advisers, bringing together banks, law firms, private equity sponsors, borrowers and senior fund managers, among others to discuss how best to incorporate ESG data into company disclosure.
- During the workshop participants discussed updates to the ELFA-LMA Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions driven by ESG regulatory and market developments.
- Senior fund manager workshop participants identified persistent gaps in ESG data and discussed with borrower participants how this could be addressed.
- Borrowers highlighted the challenges with regards to setting up strategies and polices to collect this data for their advisors and the steps they are taking to close this gap.
- Private equity sponsor, legal and banking participants highlighted evolving practices in ESG disclosure and contractual provisions and noted emerging provisions.
- Workshop participants also discussed ESG-related developments in the private debt market and with regard to litigation.
- In this Insights report, we summarise these discussions and provide a synopsis of the key changes that have been made to each chapter of the Guide in order to keep the resource up to date and helpful to practitioners seeking to incorporate ESG data into company disclosure in the leveraged finance market.

Introduction

In January 2022, ELFA hosted an ESG Disclosure Workshop to bring together leveraged finance borrowers; their advisers, including banks, law firms, and private equity sponsors; and senior fund managers to share knowledge, discuss challenges and propose solutions to the increasing need for ESG disclosure in the leveraged finance market.

The purpose of the workshop was to gather perspectives on topics covered by the ELFA-LMA Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions (the "Guide") which was first released in January 2021. These new perspectives and discussions were incorporated into second edition of the Guide, available here.

Participants represented the high yield bond, leveraged loan, CLO and private debt markets, and as such, the discussions spanned these asset classes, highlighting both their distinct issues and areas of overlap where potential synergies in ESG resources could be realised.

We welcomed the following market participants: banks, borrowers, credit rating agencies, ESG data vendors, financial advisers, senior fund managers, law firms, private equity sponsors, and trade associations. Participating institutions in both this ESG Disclosure Workshop and the previous workshop, which together informed the content of the Guide, are listed on the back cover of the Guide.

The second edition of the Guide not only reflects discussions from the workshop but also new regulatory and market developments since the Guide was first published in 2021.[1] Two new chapters are also added: a chapter on ESG in the Private Debt Market, which provides a high-level overview of key themes and emerging issues relating to the adoption of ESG in the private debt market,

[1] The changes are summarised in the Appendix.

and a chapter on ESG & Litigation Risk, which explores potential legal risks presented by the increased volume of ESG-related financings and disclosures.

In this Insights report, we summarise key themes from the workshop. We intend to continue to host ESG Workshops for advisers annually and will consider updates to the Guide following these workshops.

Why Leveraged Finance Investors Need More ESG Data and Disclosure

Availability of data will increasingly impact the availability of capital

Participants emphasised that investors' need for ESG information has increased significantly over the past year to eighteen months, and this trend will only continue, particularly in Europe. ELFA's ESG Fact Sheets provide a useful first step to engaging with borrowers on ESG topics, according to investors at the workshop, and were cited as being used as a strong starting point onto which additional information can be layered.

The need to educate borrowers regarding the increasing need to respond to such ESG information requests or risk being excluded from the investable universe of companies was emphasised by several participants. If borrowers do not provide ESG data, they may have difficulty obtaining capital in the future, but as the ESG and treasury functions tend to be in different departments, lines of communication must be established between them.

Currently, many borrowers remain unaware of the regulatory headwinds driving this increasing need for ESG data, and education is important. ELFA recently held a workshop for borrowers that explored why and how to create an ESG framework that can drive data collection, and how to communicate the ESG story once the framework is in place. We intend to host similar workshops for borrowers in the future.

LPs are driving the focus on ESG

Limited partners, the end-clients to fund managers, are increasingly selecting funds based on ESG, with a significant focus on GHG emissions. We explore the recent focus on this topic in a previously-published Insights report that covers the key takeaways from our 2021 Climate Workshop.

Senior fund manager participants noted a massive increase in ESG questions from LPs on carbon footprint data, alignment to science-based targets, and net zero commitments. Currently, given the lack of available data, managers have to often estimate carbon footprint data, which involves making many assumptions.

Carbon data and PAIs considered in investors' selection and scoring process

Borrowers and their advisers should consider a separate section in their disclosure to present information on the company's carbon footprint, given the increase in decarbonisation investment mandates and objectives; companies with net zero targets are more likely to be selected for inclusion in funds.

Workshop participants posited that soon funds will be selected based on broader ESG contributions, such as EU Taxonomy alignment, and if borrowers are not disclosing this data, they are less likely to be selected for those funds. Fund managers now have a commercial incentive to incorporate PAIs in order to reach parts of the LP market, so borrowers should be ready to disclose against these. Our ESG Fact Sheet Series was recently updated to include PAIs and other ESG KPIs in Excel format, easing the process of collecting such data.[2]

In terms of scoring, many investors use their own internal systems, and report that the ESG Fact Sheets are useful in providing a consistent approach to data collection. The recent addition of PAI data to respond to SFDR disclosure requirements is reported to be useful; SASB's materiality framework also helps.[3]

[2] All of our ESG Fact Sheets are available in a single zip file here.

[3] https://www.sasb.org/standards-overview/materiality-map/

Regulatory Considerations for Borrowers

Regulations in focus; additional resources available

Participants reported that the SFDR, the EU Taxonomy and the TCFD (particularly given the new UK legislation) are all important; new rule-making from IFRS/ISSB and existing resources from SASB, which are referenced in the UK roadmap, can show what building blocks might look like in terms of disclosure. As such, we have included this information in the Guide.

Borrowers that voluntarily report in line with NFRD demonstrate a commitment to robust ESG reporting as this can give investors what they need.

Other sources of information that we have added to the Guide based on feedback from the workshop include:

- **The Science Based Targets initiative (SBTi):** Defines and promotes best practices in emissions reductions and net-zero targets in line with climate science, providing target setting methods and guidance to companies to set science-based targets in line with the latest climate science.
- **Taskforce on Nature Related Financial Disclosures (TFND):** Aims to deliver a risk management and disclosure framework for organisations to report and act on nature-related risks.
- **Gendersmart:** A global field-building initiative dedicated to unlocking the deployment of strategic, impactful gender-smart capital at scale; maintains a list of gender benchmarks and indices. Gendersmart Jedi has a useful toolkit.

Diligence Practices and Checklists

Frontloading ESG due diligence is key and using ELFA's ESG Fact Sheets is a plus

Lawyers reported sending ELFA's ESG Fact Sheets to borrowers to complete early in the process and sending them to banks to upload onto the investor portal. Practitioners use the ESG Fact Sheets as a first step, then investors submit additional questions on top of this, giving them an opportunity to challenge and verify information provided. It was noted that it is ultimately management's responsibility to certify that such information is correct to the best of their knowledge.

Private equity sponsor participants noted that a large amount of ESG information is collected and they are getting that information to lenders, using the ESG Fact Sheets and topping them up with additional information from third party advisers. The ESG Fact Sheets are reported to be building blocks for due diligence alongside other resources. In particular, they assist with assessing materiality in the due diligence process, along with other relevant methodologies and metrics.

ESG data progressing more slowly than financial data

Consistency around materiality in ESG data is progressing more slowly than for financial data, in reporting and general availability. Participants noted that this may be linked to litigation risk that corporates face from publishing data (discussed in Chapter 7 of the Guide), so many corporates would rather wait until there are more frameworks available to give them confidence that they will not be vulnerable to ESG materiality challenges.

Law firm participants noted that the troubling part of the process was coming up with KPIs for sustainability-linked high yield bonds that the company can use and present to investors as part of the deal process. Practitioners work with management to help them find data they can track, present and report, but "it's a lot of work to come up with the right KPIs."

In general, the increase in leveraged loans including ESG margin ratchets is increasing availability of ESG data, according to workshop participants.

Sponsors view ESG as a key aspect of value creation

ESG is viewed as a key aspect of value creation by sponsors; however, some companies have few resources to devote to ESG data collection and, in some cases, they understand the requirements but do not have the numbers. However, for large cap deals and P2Ps, much more data should be available.

Materiality of ESG information

The question on materiality and ESG is pretty central. Participants noted increasingly seeing more sophisticated investors doing materiality analyses through the lens of sustainability. The opening question should be whether borrowers have done this. At the less developed end of the spectrum, they might not have done so, and some companies say that none of it is material – which is no longer true.

The ESG Fact Sheets have been an additional tool to add to the diligence toolbox, and they are used alongside other building blocks when carrying out due diligence.

ESG information should be presented in deal offering materials

In the bond market, participants agreed that ESG data must to be included in the offering memorandum; previously it had been easy to say it could be kept outside of the offering memorandum because it was not considered material, but this has changed now as investors want ESG data and consider it to be material. This will be a key challenge for the bond market in the coming years.

Participants agreed that it would be useful for an ESG section to be added to the offering memorandum so that all of the information can be found in one place, perhaps in table format where appropriate, or at the very least providing cross-references. A section on materiality assessment and description of the company's strategy would be useful at a minimum, according to an investor participant.

Many borrowers have sustainability frameworks in place, but these do not make it into the offering document. Investors noted that even where a borrower publishes a sustainability report, information tends to be scattered and difficult to find.

Selecting ESG KPIs to include in disclosure can be challenging

Participants noted that borrowers sometimes find it difficult to choose which KPIs to report on, and often find these complex to track, verify and present in reports. They agreed that regulation will drive consistency in reporting, but borrowers should focus on the bigger picture: for now, investors are willing to accept that data are not perfect, nevertheless it is essential for them to receive it so they can discuss and engage with the borrower.

Some data are straightforward to analyse, like waste, whilst other points are more amenable to qualitative disclosure (like in pharma). Not every ESG parameter can be quantified. Looking at what their industry peers are disclosing would also be useful for borrowers.

One law firm participant noted that the reporting covenant should match the information required by investors – we go into more detail on this topic in the section below "**Contractual Provisions and Other Considerations**".

LBOs present unique challenges

Participants discussed the challenges to providing ESG information in the context of an LBO, as at time of acquisition there is no information so it has to be provided later. Investors noted that in the first instance they would like to know the private equity sponsor's ESG plan for the company, and it's never too late to send the information – once the management team is up and running, information can be sent, and in any event, it makes sense to refresh ESG data a year or six months down the line.

In the private debt market, at the time of an acquisition during a competitive auction process, not much ESG information is available. When there is a refinancing event, there is more chance to gather information. The private debt market is by its nature more illiquid, so lenders can reassess their decision down the line but likely cannot sell out.

Contractual Provisions and Other Considerations

Contractual provisions for ESG reporting is desired; concern over hair trigger defaults

Workshop participants highlighted that a lot has changed with regard to ESG contractual provisions in the last year to eighteen months. Due to the information requirements imposed on investors by SFDR, senior fund manager participants noted that it would be useful for reporting covenant requirements to track Article 8 and Article 9 requirements.

To the extent an ESG reporting covenant is present, law firm participants worried about hair trigger defaults; investors noted that information could be provided on a best-efforts basis. One borrower noted that they are already allocating resources to ESG reporting, so they would not view the inclusion of a reporting requirement as a negative development especially if this functioned to widen the book. Participants suggested that this would likely become standard over the coming years.

There are many practical implications of including ESG provisions in financing arrangement, not least among them that the treasury function then needs to track ESG performance.

Leveraged loan provisions continue to evolve, high yield bonds settled on a framework

In the leveraged loan market, KPIs are not consistent (i.e., whether one- or two-way pricing, etc.) and as a result every deal seems to be "reinventing the wheel" making deal time longer.

The high yield bond market has established a general market practice more quickly due to its public nature, whilst the loan market has not yet reached this point in its development. Though this may be interpreted as negative, participants noted that this has allowed creative freedom to make different provisions and different frameworks. One participant wondered if it would actually be detrimental to seek to establish market practice in this context.

It was suggested that allowing market practice settle somewhat before suggesting template language would allow the process to emerge organically rather than crystallising it now. This was viewed as the preferred approach, as setting things in stone can have unintended consequences. Ultimately, participants noted that the provisions use the same type of mechanics but significant effort goes into setting KPIs and ensuring that these are ambitious, which is difficult to judge if the borrower has not been collecting the data over a period of time.

ESG in the Private Debt Market

Allocating resources effectively is key for private debt borrowers

A key challenge for borrowers in the private debt market in adopting ESG is allocating resources to identifying, collecting, verifying and reporting ESG data. The ESG Fact Sheet series is helpful in this regard, as it presents in one place the key ESG topics that lenders are focused on, facilitating more efficient resource allocation.

Direct relationship between borrower and lender facilitates engagement on KPIs

On the other hand, the more direct relationship between the borrower and the lender allows more collaborative engagement on which KPIs to include in the loan agreement, with some parties including provisions allowing ESG terms to be developed after signing.

New Chapter on ESG in Private Debt highlights key developments

The updated Guide now includes a chapter on ESG in Private Debt, which covers issues relating to ESG diligence and disclosure, contractual provisions, reporting, ongoing monitoring of ESG, and highlights challenges still to be overcome for the asset class.

ESG and Litigation Risk

Potential for litigation risk

Participants discussed the potential for litigation arising from ESG disclosure, failure to meet contractual obligations, and conduct, and noted how important it will be for borrowers to focus on these risks.

ESG performance-linked debt may be susceptible to litigation risk

In a new chapter of the Guide, we explore the potential for litigation relating to the choice of KPIs and the levels at which they are set in sustainability-linked debt, particularly if KPI target levels are set in line with current or projected core business performance of the borrower or issuer. KPIs that do not provide additionality may be more susceptible to challenge.

Contractual claims for deficient ESG disclosure

Disputes may arise when ESG metrics, targets or assessments are not clearly and consistently described in disclosure documents or definitive debt documents. Data gaps can hamper a counterparty's ability to assess the sustainability of debt and could lead to disputes. This further highlights the importance of close coordination among borrowers, lenders and other parties in order to accurately communicate how a company determines whether it has met its KPIs.

Important to manage ESG risk across jurisdictions

In recent years, there has been a significant increase in the laws governing ESG-related disclosures and activities. In order to mitigate against litigation risk and regulatory enforcement, it is important to understand the existing legal environment, even as it continues to develop. The new chapter explores considerations relevant to the EU, France, Germany, The Netherlands, the UK, and the US.

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Appendix

Key changes to the Guide

- Guide updated to reflect changes in the ESG investment landscape and regulatory developments during 2021 -2022.
- Post publication, in 2021 ELFA conducted two surveys for ESG (namely the ESG Investor Survey 2021 and the ESG in Private Debt 2021). The Guide contains data from both of these surveys.
- New Chapter 6 – ESG in Private debt Market
- New Chapter 7 – Guide to ESG Litigation

Chapter 1: Why Leveraged Finance investors need more disclosure on ESG Topics

Key update: Provision of an additional table that summarises UK investment related regulation.

Specific updates on SFDR:

- SFDR establishes firm- and product-level ESG disclosure requirements and it de facto creates a process for classifying ESG funds
- Relevant to all in-scope asset managers and to all financial products made available by an in-scope asset management firm; whether or not the product has an express ESG focus (although some aspects will be relevant only when a financial product has a specific ESG focus)
- Additional disclosures will be needed where a financial product:
  - Promotes environmental or social characteristics (i.e., Article 8 product); or
  - Has sustainable investment or a reduction in carbon emissions as an objective (i.e., Article 9 product)
- The European Supervisory Authorities (ESAs) have developed regulatory technical standards (Level 2 RTS) to give more detail on: (i) what information the various disclosures should contain and (ii) how this should be presented. Following a series of changes, the application date of the Level 2 RTS has now been delayed until 1 January 2023
- Meaningful impact although application of certain disclosure obligations (i.e., Level 2 RTS) is not immediate

Specific updates to Taxonomy Regulation:

- Establishes a classification system to be used in determining the degree to which an economic activity can be described as being "environmentally sustainable"
- Passed into law and applicable from January 2022
- The Framework Regulation establishes a phased application of disclosure requirements. Asset managers at an entity level will be required to report their underlying investments eligibility to the taxonomy as a % of total AUM starting Jan 1, 2022

Specific updates to Suitability Delegated Regulation:

- Passed into law on 2 August 2021 and applicable from 2 August 2022

Specific updates to integration of sustainability into a firm's systems and controls:

- Passed into law on 2 August 2021. The measures made under AIFMD and the UCITS Directive will apply from 1 August 2022 while the measure made under MiFID 2 will apply from 22 November 2022

Chapter 2: Regulatory considerations for borrowers

Key update: Post publication of the Guide, the International Sustainability Standards Board (ISSB) was established. We have updated this chapter to highlight their work on developing a global baseline for sustainability reporting. We also updated the chapter to reflect the Corporate Sustainability Reporting Directive (CSRD) that was adopted by the European commission shortly after publication.

Specific updates on TCFD:

- As of January 2022, the number of TCFD supporters surpassed 3,000 organisations from 92 countries with a combined market capitalisation $27.2 trillion.

Specific updates on Taxonomy Regulation:

- On 9 December 2021, a delegated act supplementing the Taxonomy Regulation and establishing the technical screening criteria for climate change mitigation and climate change adaptation objectives was published in the Official Journal and has applied since 1 January 2022. A draft second delegated act for the remaining objectives is expected to be published in 2022.
- The Taxonomy Regulation has also introduced new disclosure requirements for financial market participants offering financial products in Europe and for companies subject to disclosure requirements under the NFRD. On 10 December 2021, a delegated act supplementing Article 8 of the Taxonomy Regulation was published in the Official Journal has applied since 1 January 2022 (the Delegated Act). The Delegated Act specifies the content, methodology and presentation of information to be disclosed by financial and non-financial undertakings concerning environmentally sustainable economic activities.
- On 2 February 2022, the European Commission approved in principle a Complementary Climate Delegated Act including, under strict conditions, specific nuclear and gas energy activities in the list of economic activities covered by the Taxonomy. The Complementary Delegated Act was formally adopted in all EU official languages on 9 March 2022 and transmitted to the co-legislators for their scrutiny on 10 March 2022.
- On Application: Under the Delegated Act, in-scope non-financial undertakings will be required to disclose Taxonomy-eligibility from 1 January 2022 and Taxonomy-alignment from 1 January 2023. In-scope financial undertakings will be required to disclose Taxonomy-eligibility from 1 January 2022 and Taxonomy-alignment from 1 January 2024.

Chapter 3: Diligence Practices

No material changes.

Chapter 4: Drafting Considerations and ESG Roadmap

Key update: This chapter was updated to take into account the CSRD regulation.

Specific updates on relevant regulatory considerations:

- The CSRD, which is expected to directly impact nearly 50,000 entities, will require in-scope companies to annually report in compliance with rigorous new European sustainability reporting standards. The SFDR and the proposed CSRD, along with continued investor demand, has accelerated transactional ESG due diligence and the incorporation of ESG disclosure in the high yield market.

Specific updates on ESG disclosure in Offering Memorandum

- Borrowers have the option to weave ESG disclosure throughout offering materials where relevant, ensuring that it ties in with wider business disclosure in a manner that is relevant, proportionate and easy to follow. By incorporating ESG information into each section of the offering memorandum, companies will be able to paint a fuller picture of the risks and opportunities of ESG factors on their business as a whole while conveying a genuine commitment to ESG principles.
- Borrowers may also consider including a separate section summarising their ESG policies and highlighting key ESG topics with cross-references to more fulsome disclosure present in other parts of the offering memorandum. Investors are increasingly under significant time pressure when reviewing company disclosure in a high yield bond offering and, as such, this approach may make it easier for them to access the information they require.
- Borrowers may wish to consider including a section highlighting their ESG / sustainability policy and including key data (e.g., a table with Principle Adverse Sustainability Impact (PASI) information or ESG key performance indicators). A description of the borrower's ESG materiality assessment could also be included in this section, along with a summary of its ESG policies with cross-references to other relevant sections of the offering memorandum where these concepts are explored in more detail.

Specific updates on other methods of ESG disclosure

- In addition to ESG disclosure in offering documents, companies can provide further evidence of their ESG strategy, goals and KPIs, via website publications. These can include standalone ESG, or sustainability, reports that are based on one or more of the voluntary global ESG disclosure frameworks (e.g., TCFD, The Value Reporting Foundation). Additionally, in connection with ESG bond offerings, companies tend to publish ESG financing frameworks on their websites that summarize ESG strategies and policies along with alignment with applicable ESG bond principles, such as ICMA's Sustainability-Linked Bond Principles.

Specific updates on ESG ratings:

- It should be noted that the EU has proposed the establishment of a registry of approved third-party ESG ratings organisations in connection with its European Green Bond Standard that would be supervised by the European Securities Market Authority. This registry would provide for a centralized accreditation regime for such third parties, requiring them to have "adequate qualifications, professional experience, and independence...to ensure adequate investor protection."

Chapter 5: Contractual Provisions

Key update: The chapter has been updated to reflect developments in ESG contractual provisions in the European leveraged market and highlights new provisions that emerged during 2021 – 2022.