ESG MONITOR

H1 2023 European Sustainability-Linked Loans Wrap: Robust ESG Reporting Requirements Improve Transparency for Lenders in Trade Off for Lower ESG Margin Adjustments

Sustainability-linked loan issuance in Europe has been buffeted by the wave of amendments and extensions seen in the first half of 2023. Sustainability-linked loans, or SLLs, have grown rapidly to comprise around half of all leveraged loans in 2021 and 2022. Compared with the first half of 2022, the volume of SLLs issuance dropped significantly in the first half of 2023. We summarize this may be because of the lack of new money deals and the **dominance of amend-and-extend deals** in the leveraged loan market in which borrowers recycle covenant packages of existing loans and are cautious about building in new features, such as ESG Margin Ratchets. If we strip out A&Es from the volumes of leveraged loans in the first half of 2023, SLLs comprised around half of the European leveraged loans, which is consistent with 2022.

Despite the lack of new loan issuance, there have been developments in sustainability-linked provisions in SLLs. In this article, we will chart these developments, trends in margin adjustments, requirements for disclosure and external verification to prevent greenwashing, amendments to sustainability targets, which targets have been the most prevalent and review other key features of the SLLs market.

As the integrity of the ESG market continues to be a critical topic, we also looked at some of the market and regulatory developments of the first half of 2023 aiming to address some of the concerns raised by market participants, including the lack of transparency and trust towards this instrument and the scarcity of applicable standards when it comes to ESG data.

This article follows our H1 2023 European Sustainability-Linked Bonds Wrap, examining similar trends in European high yield bonds, which is available **HERE**, as well as our H1 2023 European Leveraged Loans Wrap, which looks at trends in the broader European leveraged loan market and is available **HERE**.

Key Takeaways

- **Overall Share of Sustainability-Linked Loans in the European Leveraged Loan Market Declined in the First Half of 2023:** SLLs comprised only **23%** of the overall European leveraged loan market, down from **53%** in 2022. However, when amend-and-extend transactions, or A&Es, are excluded, this rises to **47%** making it consistent with the previous year.

- **The Range of Margin Adjustment for Failure to Achieve ESG Targets Narrowed Further in the First Half of 2023** with plus/minus 7.5 bps being the most common adjustment in the first half of 2023 compared with plus/minus 10 bps in 2022. **No European SLLs** offered an adjustment above plus/minus 10 bps in the first half of 2023. On a more positive note for lenders, there was an increase in SLLs where a borrower's failure to provide the required documentation evidencing performance against the sustainability criteria automatically results in a margin adjustment.

- **Transparency Improves as More Detailed Reporting is Required:** More complete and detailed information in the form of a sustainability report, either supplied by the borrower or an independent third-party, is required to be delivered in **nearly all of SLLs** compared with **just under 50% in 2022**. Nearly all of SLLs require external verification of sustainability information evidencing performance against the agreed key performance indicators, or KPIs.

- **SLL Amendment Provisions Continue to Proliferate, With Consent of Majority Lenders Required in Most Cases: Nearly all (88%)** of sustainability-linked loans contain provisions to make amendments to sustainability performance targets, or SPTs / KPIs following a significant event. In a majority of cases **(57%)** consent of the majority lenders is required while the remaining loans require no consent from lenders but do require certification from an external verifier.

- **KPIs remain firmly focused on Environmental Issues Although Social Targets Appear:** Sustainability targets in SLLs continue to focus on environmental concerns, emphasizing climate change in the first half of 2023. Although we've seen some social KPIs concerns regarding working conditions and safety in the workplace, on a more negative note we've seen diversity KPIs disappear along with governance KPIs.

- **Lenders Rejected the Insertion of ESG Margin Ratchets in A&E Deals:** The scope for loosening of protections and including new aggressive terms in leveraged loans was limited in the first half of 2023 as the market was **dominated by A&Es**. A&Es largely recycle the covenant package of their existing debt. When two borrowers attempted to insert an ESG Margin Ratchet into the terms of their extended debt, lenders rejected the opportunistic insertion.

This article is based on senior facilities agreements, or SFAs, featuring sustainability-linked provisions in the European leveraged finance market, governed primarily by the laws of England and Wales, as analyzed by Reorg EMEA Covenants from from Jan. 1 to June 30 ("H1 2023 SLLs"). From time to time in this article we compare H1 2023 SLLs with SLLs reviewed from Jan. 1, 2022 to Dec. 31, 2022 (2022 SLLs), Jan. 1, 2021 to Dec. 31, 2021 (2021 SLLs) and their respective half-year periods.

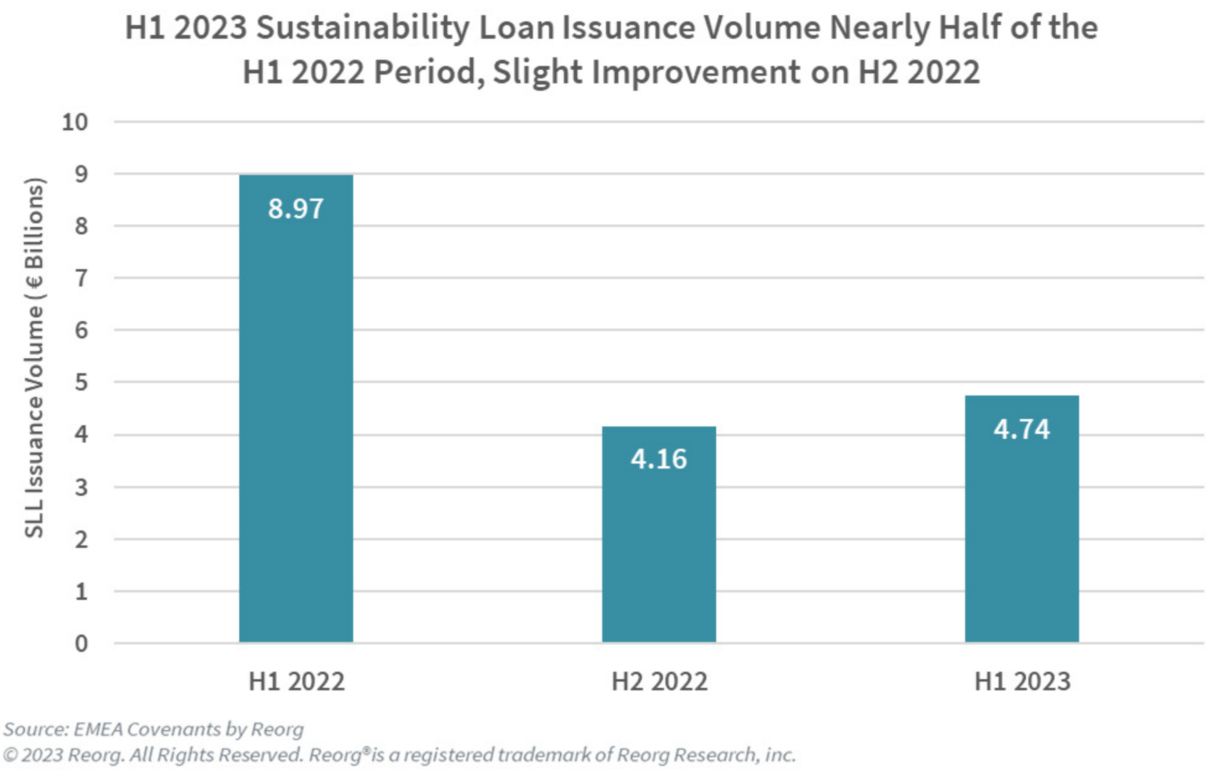
Capitalized terms used in this article are defined in the glossary at the end of this report, unless elsewhere defined in this report.

A note of caution: Given the light volume of deals in the first half of 2023 and 2022, the statistics for SLLs during these periods are more sensitive to distortion. In most instances, the statistics suggest identifiable market trends, but in a few instances they showed movements that could equally be explained by data distortion.

An Overview of Sustainability-Linked Loans

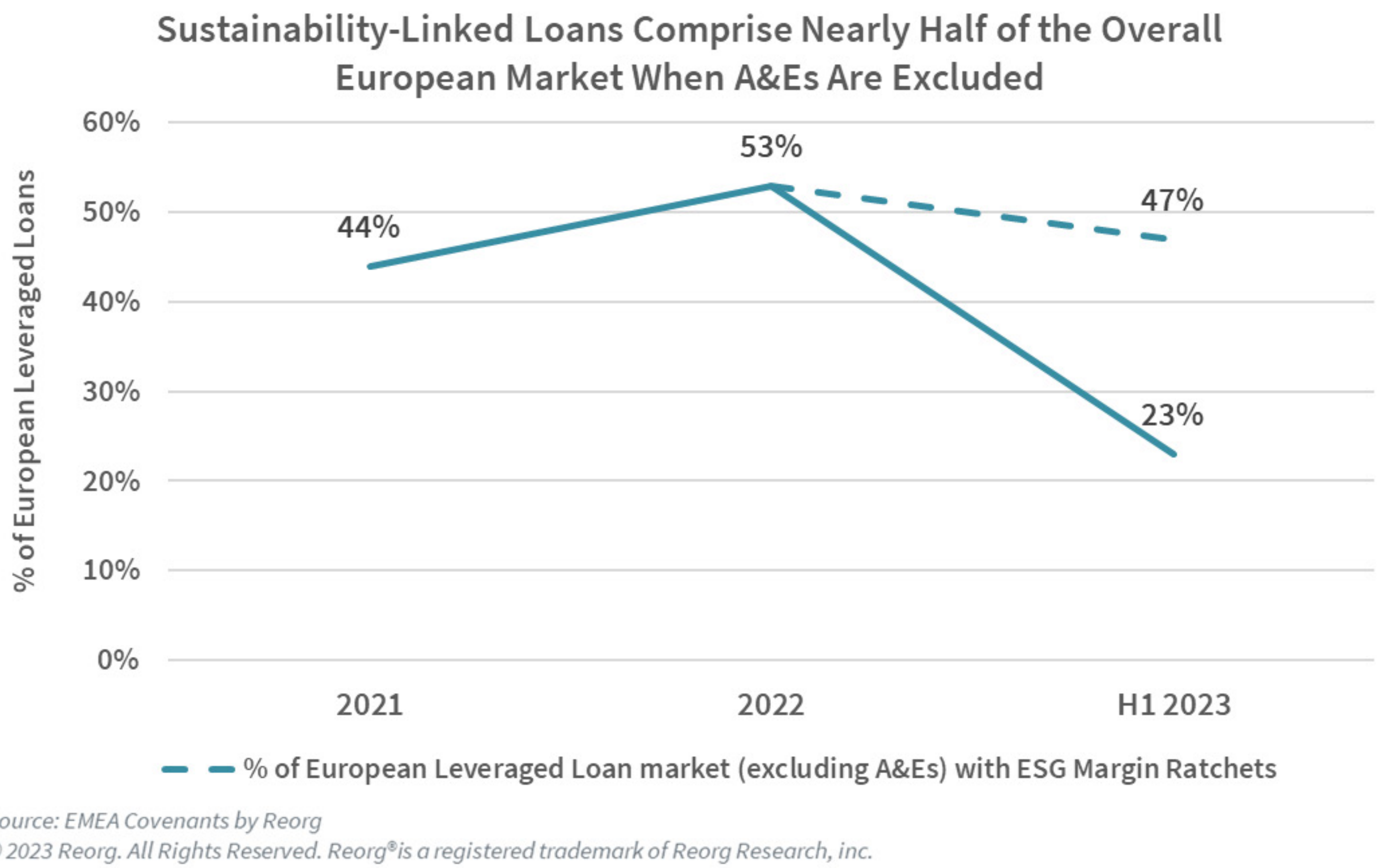
Overall Volume of SLLs Issuance Nearly Halves in H1 2023 Vs H1 2022

Based on Reorg data, SLLs issuance in the first half of 2023 amounted to **€4.74 billion**. The SLLs issuance in the first half of 2023 was slightly higher than the €4.16 billion issued in the second half of 2022 but was significantly lower than the **€8.97 billion** in the first half of 2022.



Sustainability-Linked Loans Overall Share of the Market Falls, Consistent With 2022 When A&Es Are Excluded

Only **23%** of the European leveraged loans reviewed by Reorg in the first half of 2023 included an ESG Margin Ratchet (as defined in the Glossary section below). This marks a significant decline from 2022 where **53%** of European leveraged loans included an ESG Margin Ratchet. Although when A&Es are excluded, SLLs share of the overall European markets shoots up to **47%**, more in line with 2022 and 2021 levels. This can largely be explained by the fact that A&Es tend to recycle the terms of their existing debt with lenders unlikely to accept looser or newer terms.



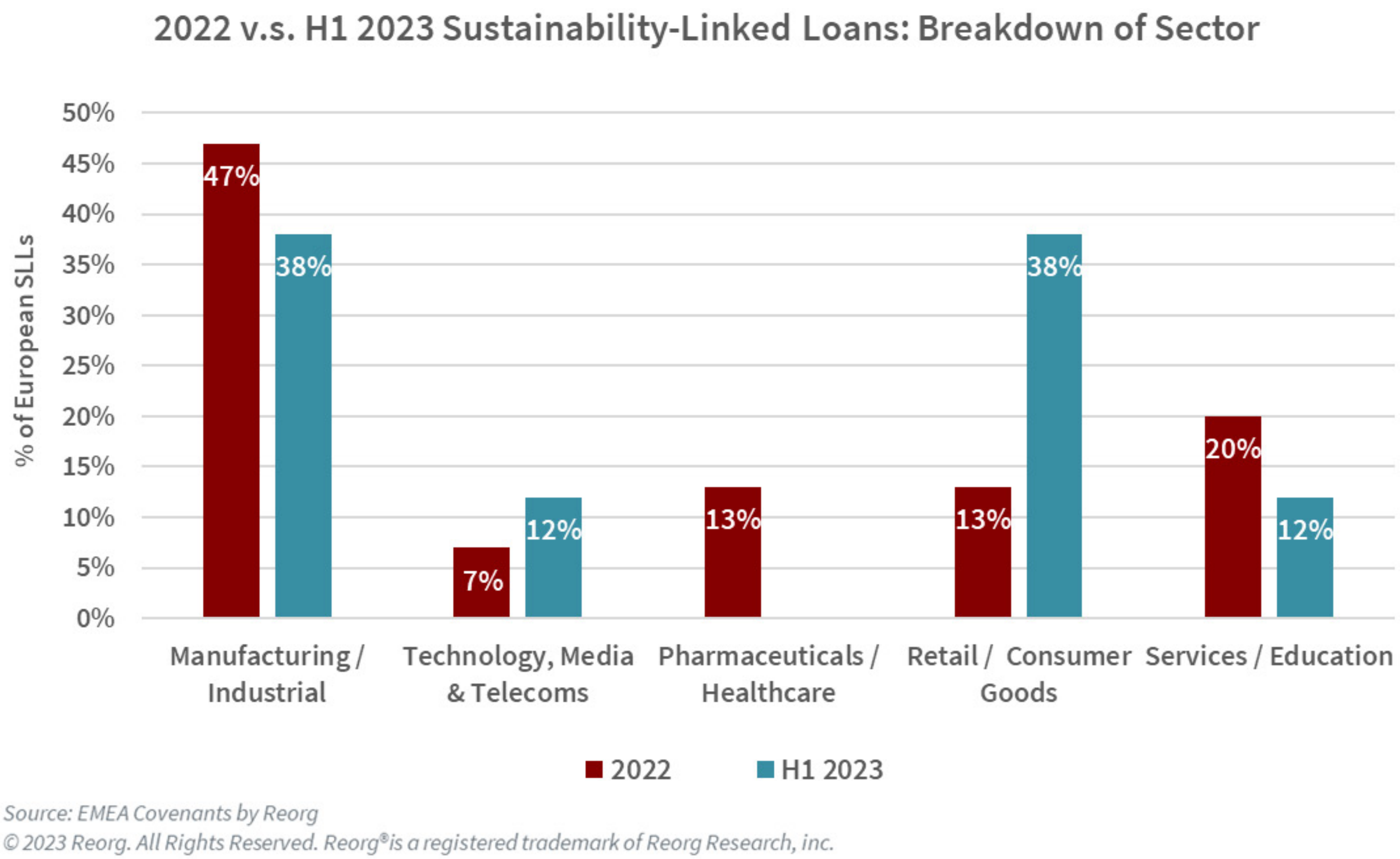
It should be noted that borrowers tried to introduce ESG Margin Ratchets into two A&Es loans in the first half of 2023 before lenders successfully pushed for their removal. However, this may be more a commentary on the unwillingness of lenders to accept changed terms in an A&E than on their willingness to accept ESG Margin Ratchets more generally.

Manufacturing / Industrial Sectors Still Dominates European Sustainability-Linked Loan Market as Retail Share of the Market Jumps in H1 2023

Borrowers in the manufacturing and industrial sectors accounted for **38%** of SLLs in the first half of 2023, a drop from **47%** in 2022.

There was a significant increase in borrowers from the retail and consumer goods sector issuing SLLs in the first half of 2023 (**38%**) compared with just 13% in 2022.

There were no SLLs from borrowers in the healthcare and pharmaceutical sector in the first half of this year compared with 13% in 2022.

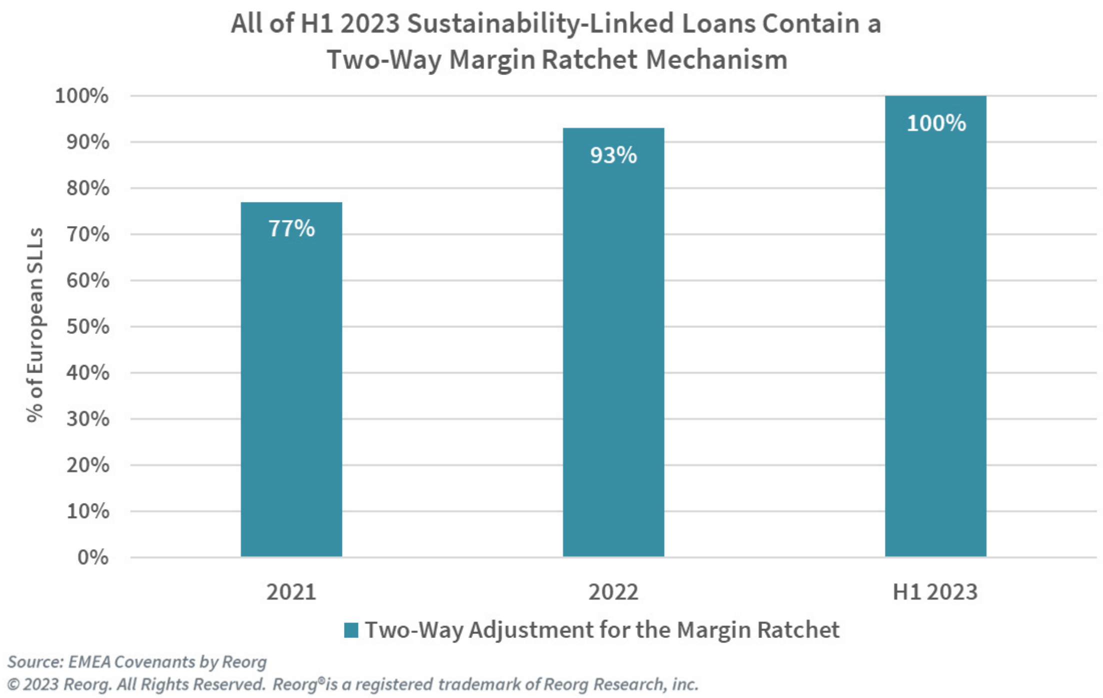


Economics: Trends in ESG Margin Ratchets

All of H1 2023 SLLs Apply Two-Way ESG Margin Ratchet Adjustments

Typically, in a SLL an annual margin reduction applies if the borrower meets the SPT. If the borrower's performance does not meet the SPT for that year, the margin will increase. This "carrot-and-stick" approach known as a "two-way" ESG Margin Ratchet was adopted by all of H1 2023 SLLs.

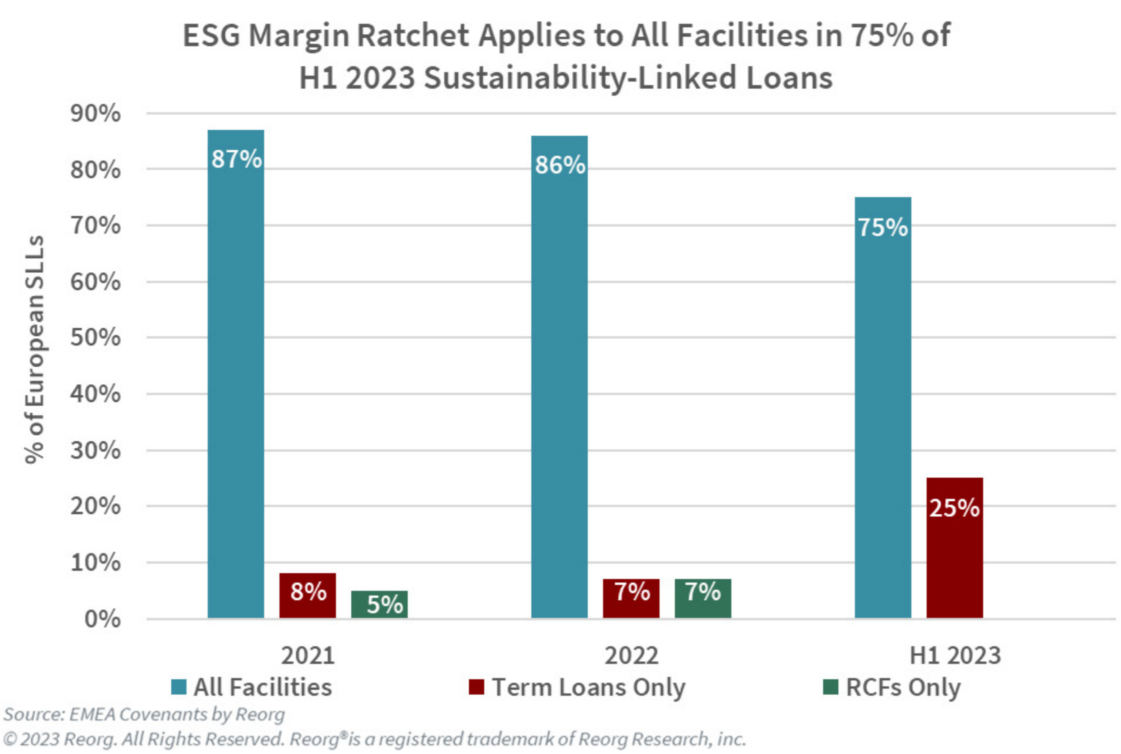
In 2021, a considerable minority (**23%**) applied only a one-way ratchet that would either only increase or decrease the margin dependent on meeting the KPIs / SPTs. This position has moved to where "two-way" ESG Margin Ratchets are now the standard in European SLLs. However, the "two-way" mechanism in SLLs contrasts with European sustainability-linked bonds, or SLBs, where the standard is to **only increase** the coupon if the company fails to meet its KPIs / SPTs or fails to provide the relevant SPT Documentation.



What Facilities Does the ESG Margin Ratchet Apply to?

To maximize the effectiveness of the ESG Margin Ratchet it should apply equally across all facilities. Where the ESG Margin Ratchet applies only to the RCF and not the term loans, the effectiveness of the ESG Margin Ratchet as an incentive for the borrower to make ESG improvements is significantly weakened as the RCF is unlikely to be fully drawn at all times.

The **overwhelming majority of European SLLs in the first half of 2023 apply the margin ratchet adjustment mechanism to all facilities within the SFA.** However, in contrast to 2021 and 2022, a significant minority (**25%**) applied the ESG Margin Ratchet solely to the term loan facility while none applied only to the RCF.



H1 2023 SLLs Offer Modest ESG Margin Ratchet Adjustments

In the first half of 2023, the application of the ESG Margin Ratchet could vary a borrower's cost of borrowing in a range from plus/minus 2.5 bps to plus/minus 10 bps. This is in contrast with 2022, where noncompliance with sustainability targets could result in the margin increasing by up to 15 bps. As shown in the table below, the range of ESG Margin Ratchet step-downs and step-ups is narrowing.

In this year's SLLs, noncompliance by a borrower with its sustainability targets would have less of a bite compared with 2022 SLLs. **In 50% of the H1 2023 SLLs, only a modest plus/minus 7.5 bps upward adjustment was offered to lenders if a borrower failed to meet its sustainability targets.**

This is in contrast to 2022 where plus/minus 10 bps accounted for the largest share of adjustments (**47%**), although plus/minus 7.5 bps was also the largest adjustment in 2021. No H1 2023 SLLs offered an adjustment over 10 bps whereas in 2022 and 2021 a small minority offered a more hefty adjustment.

Cumulative Margin Adjustments	2021	2022	H1 2023
2 bps	3%	0%	0%
2.5 bps	0%	7%	12.5%
5 bps	11%	0%	12.5%
7.5 bps	47%	13%	50%
10 bps	32%	47%	25%
12.5 bps	3%	0%	0%
15 bps	8%	7%	0%

The modest ESG Margin Ratchets currently seen in the SLL market are in contrast with the sustainability-linked bond market, where the most common coupon increase in the first half of 2023 was 25 bps and where a significant number of bonds also offer a redemption premium for failure to hit sustainability targets.

Increased Penalties for Failure to Provide the SL Documentation

SLLs may also apply an automatic increase to the margin if the borrower fails to provide the required documentation evidencing its performance against the SL Criteria ("SL Documentation"). The SL Documentation, to be delivered annually, typically includes:

- **For SLLs based on ESG Rating:** a copy of the rating/score from the ESG ratings agency;
- **For SLLs based on SPTs:** a company certificate and/or sustainability annual report setting out the borrower's performance against the KPIs.

In a positive development, in 87% of first half 2023s SLLs, the margin would automatically increase if the borrower fails to provide SL Documentation, a significant jump from 2022 where this automatic increase only applied in 60% of SLLs.

As was always the case in prior years, the failure to deliver the SL Documentation will not be a default under the relevant SLL. Given that the failure to deliver certain other information, for example annual financial statements, does typically trigger a default, it will be interesting to see whether this changes in the future to punish underperforming borrowers, given the current modest pricing adjustments.

As shown in the table below, 20% of SLLs in 2022 required an automatic margin increase if the SL Documentation a borrower provided to its lenders contained a qualification by the external verifier. In our 2022 report, we wrote that we expected this margin trigger would continue to increase to safeguard against the risk of greenwashing. However, in the first half of 2023, this appears not to be the case. We'll be keeping an eye on the second half of 2023 to see whether more SLLs include this provision to ensure that borrowers provide full disclosure to and and cooperate with their external verifiers.

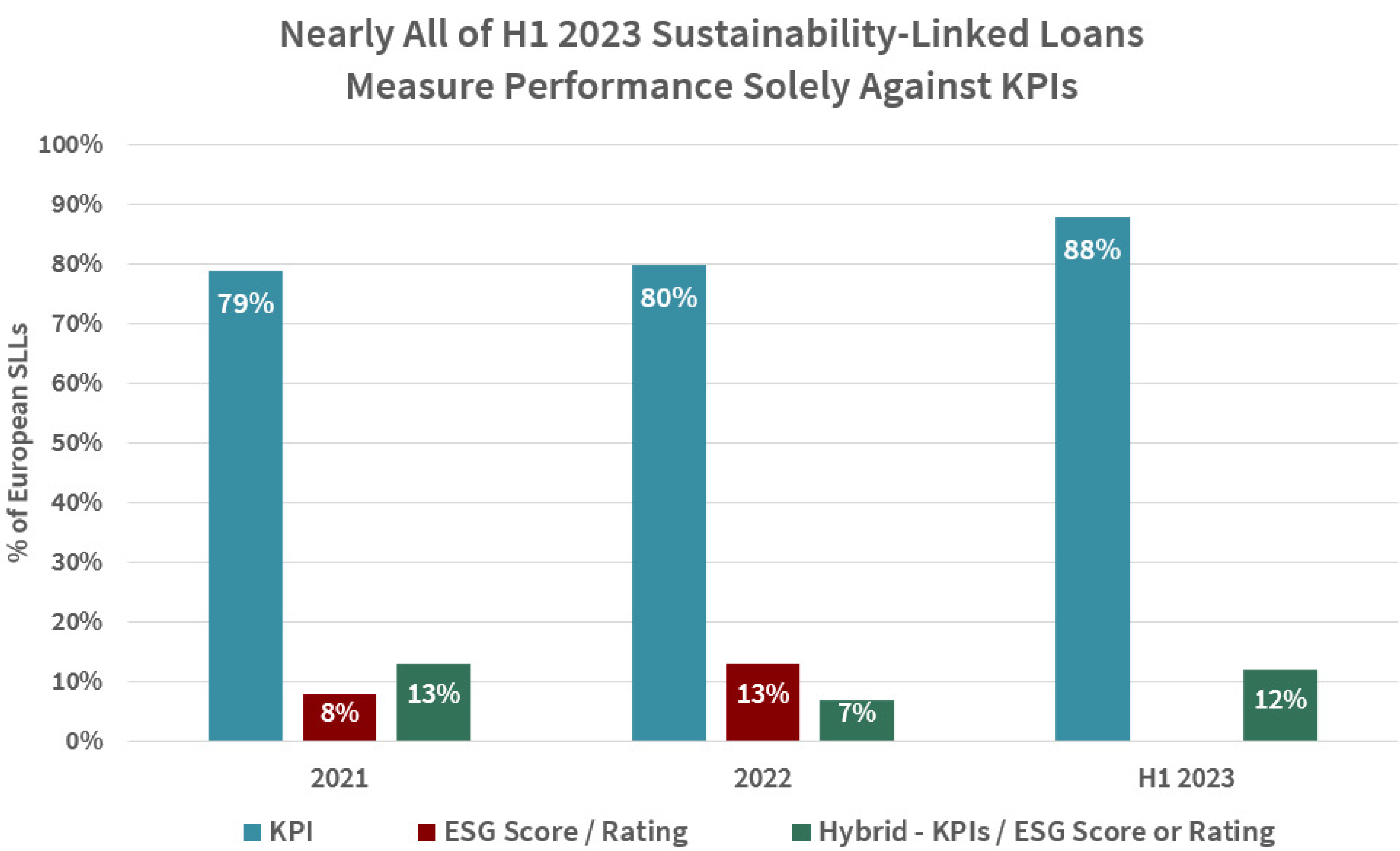
Triggers	2021	2022	H1 2023
SLLs with a margin increase if SL Documentation is not provided	74%	60%	88%
SLLs with a margin increase if External Verifier qualifies SL Documentation delivered by it	5%	20%	12%

Sustainability KPIs and ESG Ratings

Performance Continues to Be Dominated by KPIs

Similar to a leverage-based margin ratchet, a margin increase or decrease under the ESG Margin Ratchet will apply depending on the borrower's performance against the SL Criteria. Borrowers' performance in SLLs can be measured in different ways: **KPIs / SPT - based , ESG Rating based** or a **Hybrid approach** (described in depth **HERE**).

Measuring ESG performance against predetermined KPIs featured in all of H1 2023 SLLs, with a small minority (12%) adopting a hybrid approach. No H1 2023 SLLs measured performance solely against an external ESG score/rating while in 2022 a small minority (13%) of SLLs opted to do so.



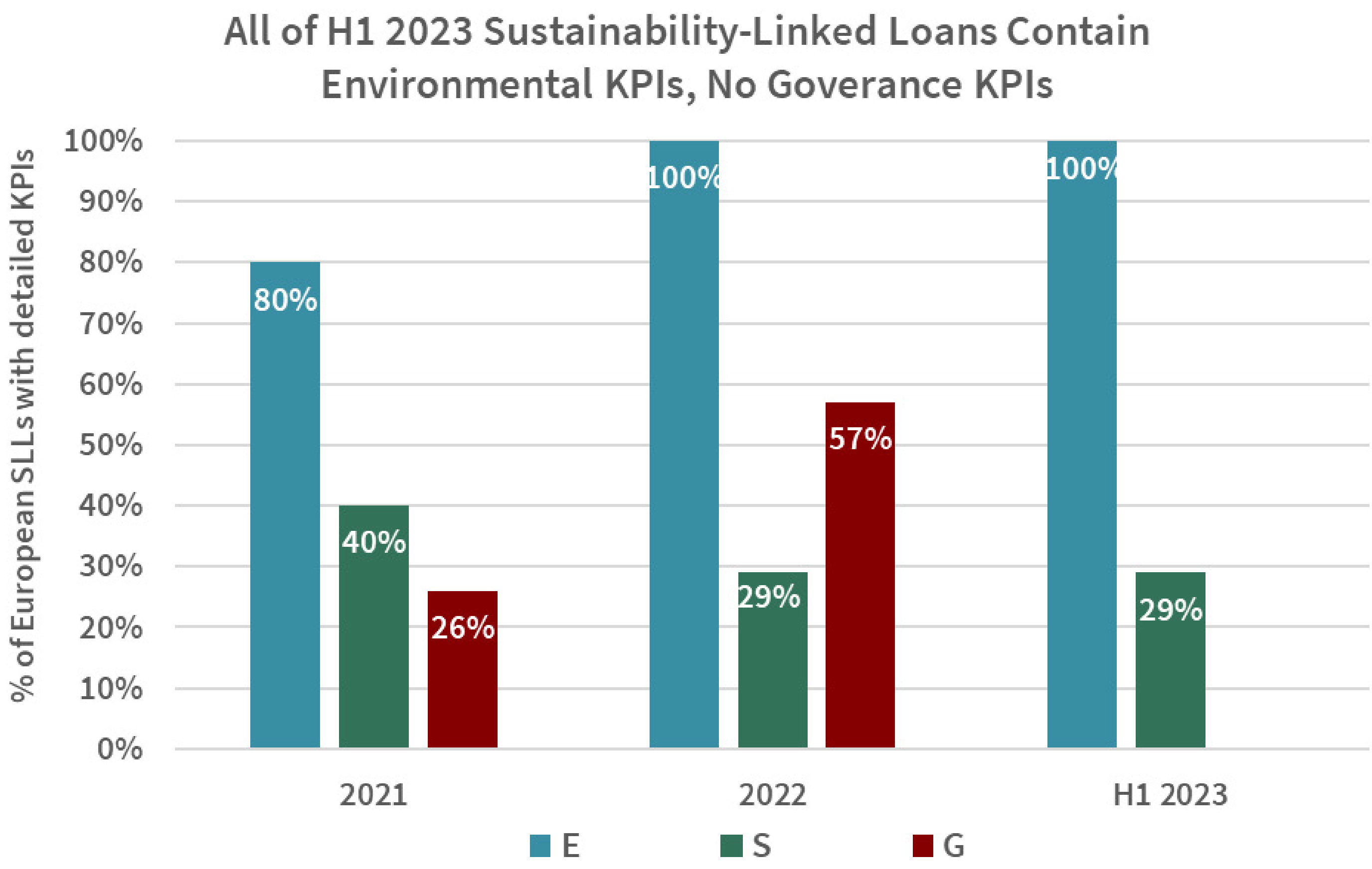
Source: EMEA Covenants by Reorg

E, S or G? Environmental Concerns Dominate and Governance KPIs Vanish

As was the case in 2022, environmental KPIs featured in all H1 2023 SLLs. The popularity of environmental KPIs / SPTs is likely because they are seen as the easiest to track and more impactful in order to tackle climate change issues.

Governance KPIs did not feature in any H1 2023 SLLs despite featuring in **57%** of SLLs in 2022. The use of social KPIs continue to feature in H1 2023 SLLs (**29%**) consistent with what we saw in 2022 but short of its high of 40% in 2021. Governance KPIs linked to improving business ethics or social KPIs tied to enhancing youth and female diversity among management roles, which were previously seen in 2022 and 2021, were not favored in H1 2023.

One possible reason for the exclusion of social or governance related KPIs could be the difficulty in measuring the actual impact of such KPIs in terms of sustainability performance. However, this reason alone should not result in exclusion of the S or G elements as KPIs for European SLLs.

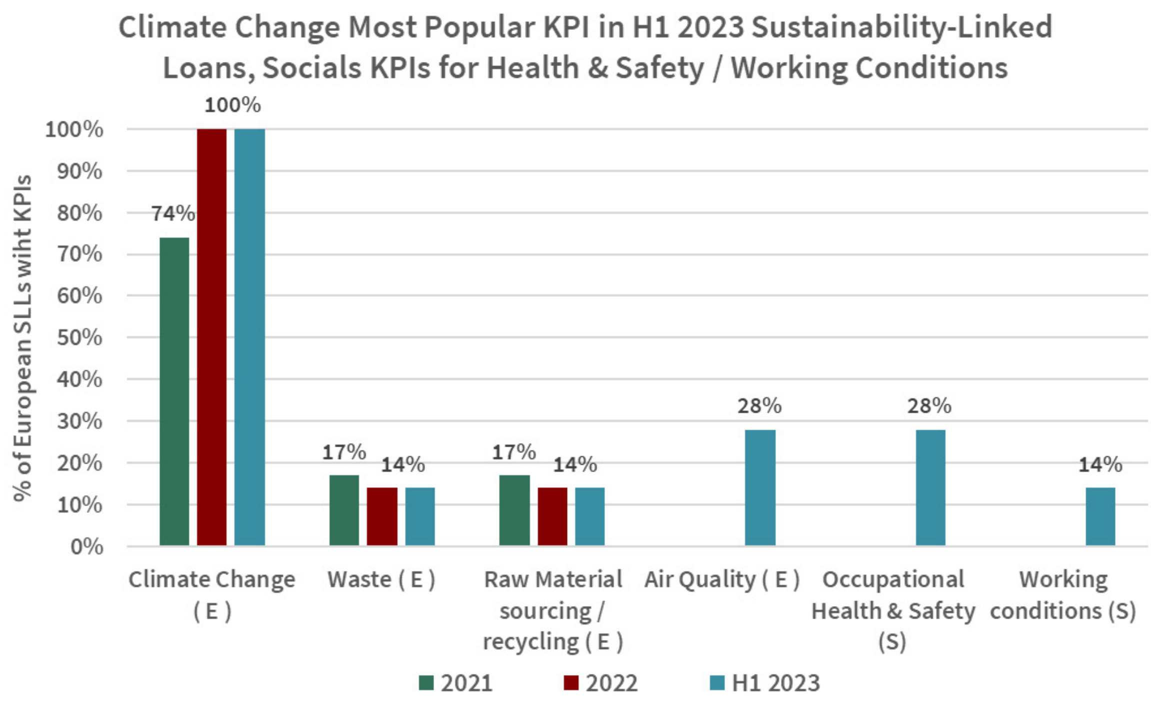


Source: EMEA Covenants by Reorg

Climate Change Continues to be Most Popular KPI

As was the case in 2021 and 2022, climate change features in all H1 2023 SLLs with detailed KPIs. All of the climate change KPIs were focused on the reduction of the scope 1 and scope 2 greenhouse gas emissions.

KPIs based on air quality (28%) and social concerns such as health & safety in the workplace (28%) and working conditions (14%) appeared in a handful of H1 2023 SLLs, after an absence since prior to 2021.

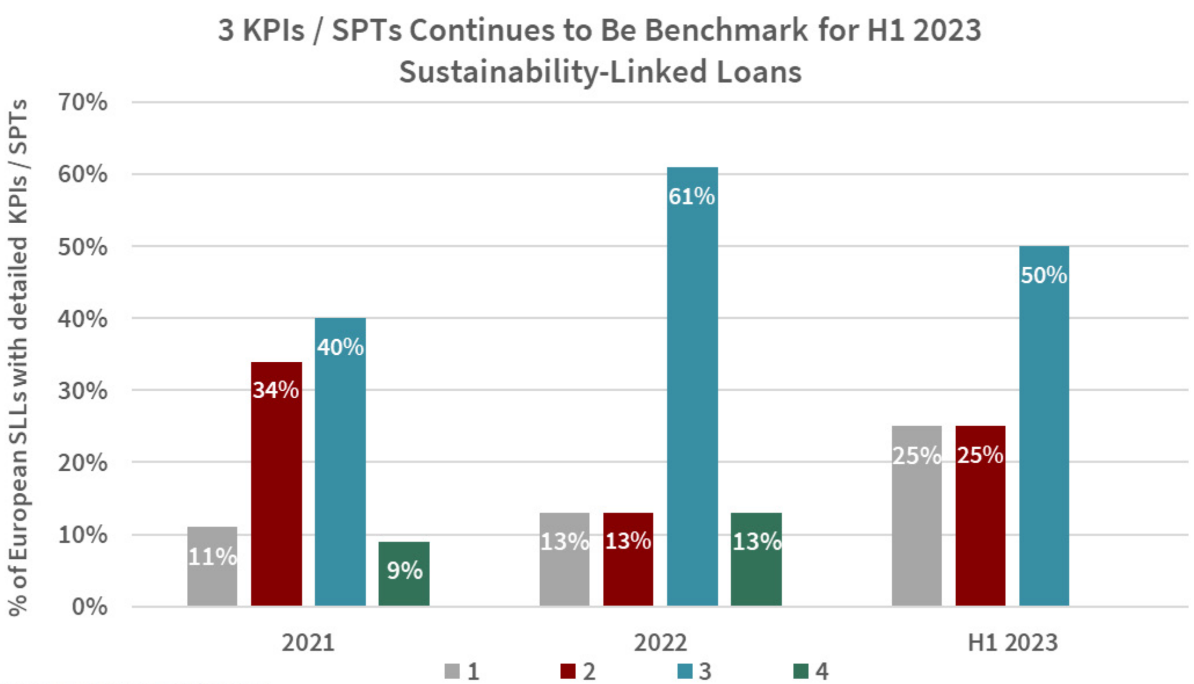


Source: EMEA Covenants by Reorg

3 KPIs/SPTs Most Frequent in H1 2023

In SLLs, borrowers have typically pegged their margin reductions (or increases, as the case may be) on achieving between one and four sustainability targets. A majority of SLLs include a pricing reduction (or increase) for every SPT achieved.

Largely consistent with the **trend** seen in 2022 and 2021, in H1 2023 50% of loans set the borrower **three KPIs/SPTs** to meet. As illustrated below, the remaining loans only required one or two SPTs to be met.

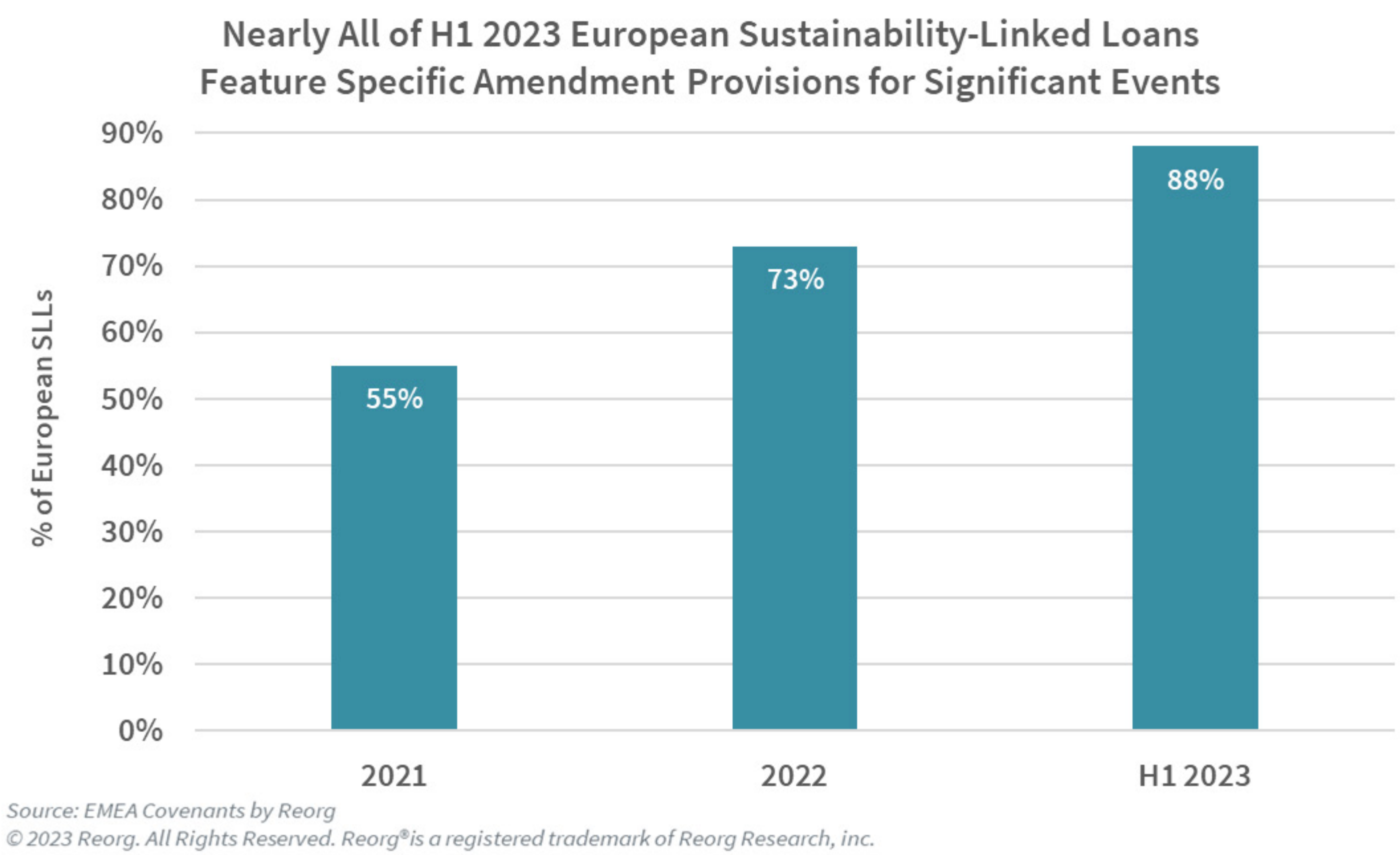


Source: EMEA Covenants by Reorg

Amending Sustainability Targets Following a Significant Event (“Rendez-vous Clause”)

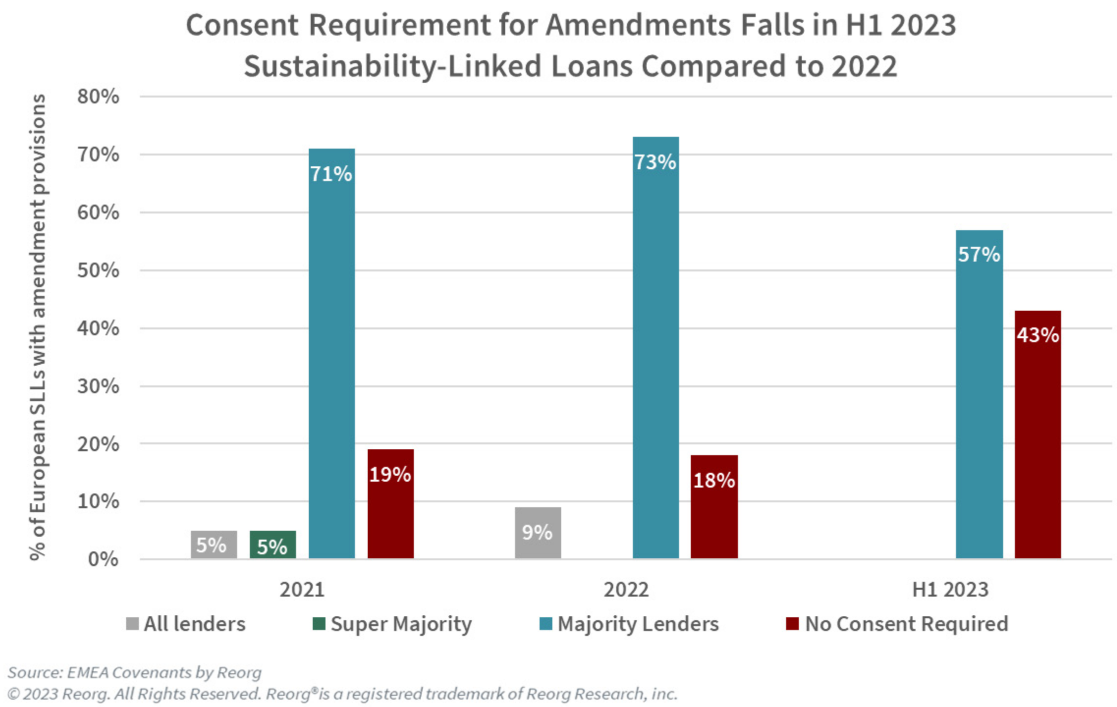
The amendment provisions in European SFAs generally state that any amendment can be made with majority lender consent, unless expressly stated. One common exception is for amendments resulting in a reduction to the margin, which requires the consent of all affected lenders. Amendment of KPIs / SPTs (including changes to KPI calculation methodology) could indirectly lead to a reduction in margin (for example if the SPTs is made easier to meet thereby triggering a margin decrease or avoiding a margin increase), and therefore, under the standard amendment provisions, may require the consent of each affected lender.

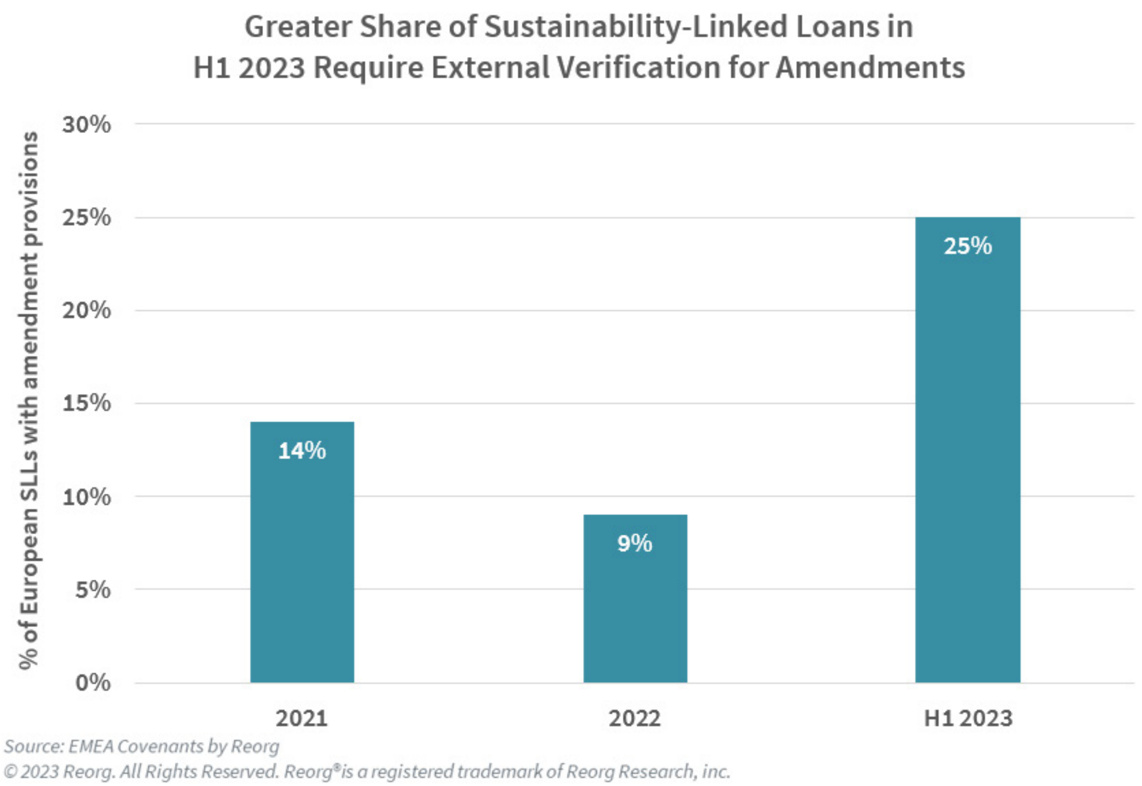
However, over the lifetime of an SLL, an acquisition, disposal, investment or other significant event affecting the borrower may cause the KPIs originally established or the levels originally set for SPTs no longer to be appropriate. Accordingly, certain amendments provisions have appeared in documentation to allow for the company to amend or update any KPI / SPTs to account for any M&A activity, any significant events or changes in the regulatory environment. These specific amendment provisions, called a “rendez-vous clause” by the LMA in **Guidance on Sustainability Linked Loan Principles**, featured in nearly all (**88%**) of the H1 2023 SLLs, up from **73%** of 2022 and **55%** in 2021 SLLs.



In **57%** of H1 2023 SLLs with specific amendment provisions, consent is required from lenders representing 50.01% of commitments (Majority Lenders) to amend KPIs / SPTs. Majority Lender consent remains the largest cohort, although by a smaller margin than in previous years.

A worrying trend emerging from H1 2023 is that **43%** of SLLs require no consent from lenders to effect amendments, a significant jump from **18%** in 2022. However, it should be noted that in all the SLLs that did not require consent from lenders, the amendment still has to be supported by an External Verifier. Verification of the changes to the KPIs / SPTs by an External Verifier generally has risen to **25%** of all H1 2023 SLLs with amendment provisions, a significant jump from **9%** in 2022.





Disclosure, Reporting and External Verification Requirements on the Rise in 2023

Positively in H1 2023, SLLs have enhanced transparency through more rigorous disclosure, reporting and external verification requirements. Transparency is vital in combating concerns over "greenwashing" by ensuring clarity as to how calculations are made when assessing whether SPTs have been achieved.

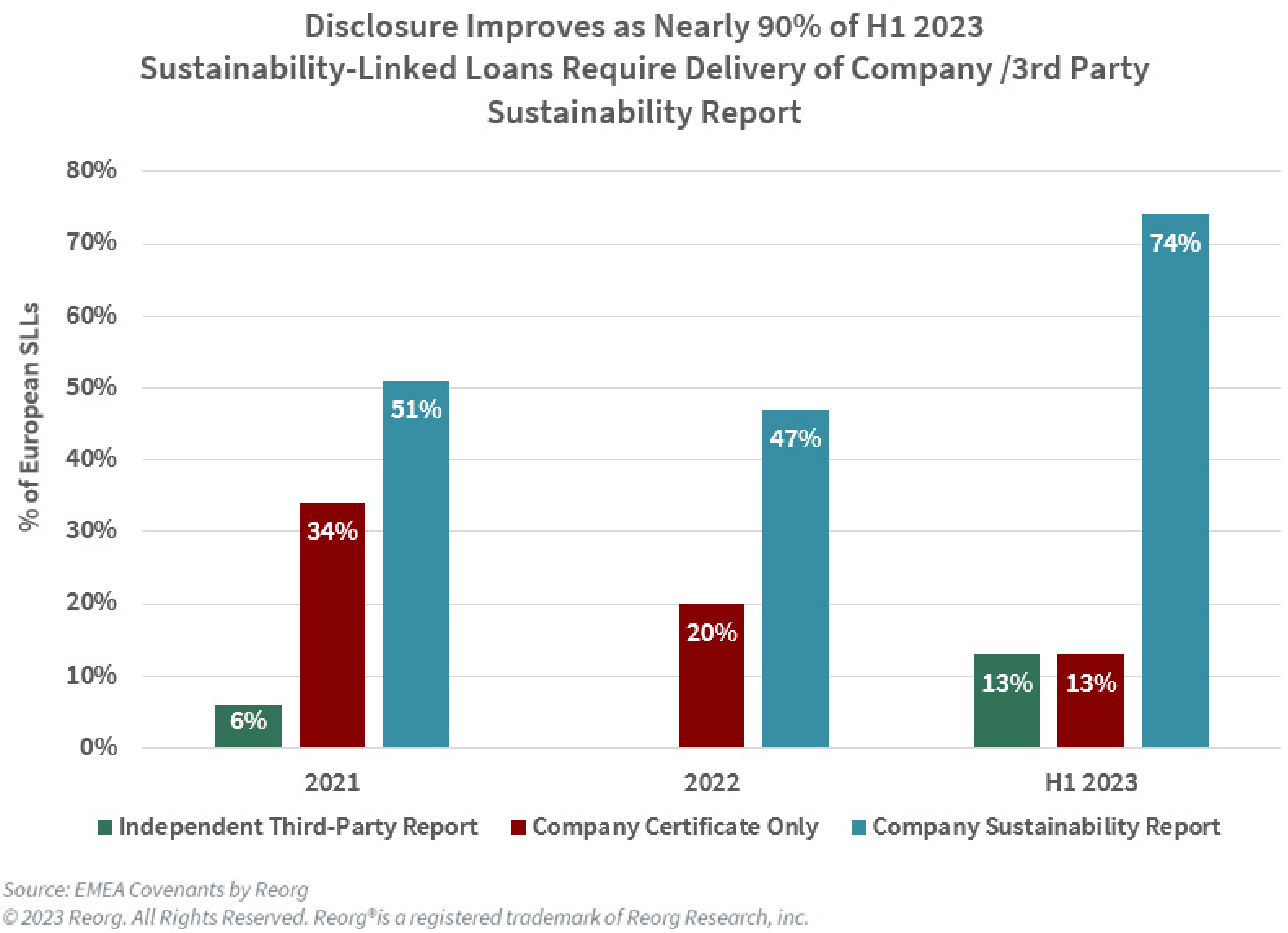
In order to meet the SL Criteria, borrowers are required to provide SL Documentation, **typically on an annual basis.**

For **SLLs based on an ESG Rating**, deliverables can include a **copy of the rating from the ESG ratings agency** or company certificate/notification stating the ESG Rating.

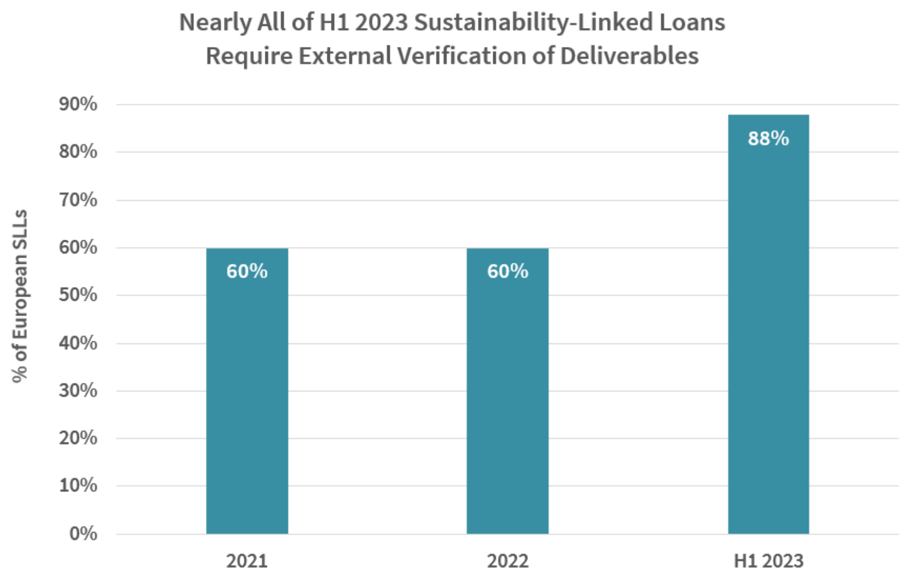
For **SLLs based on SPTs**, documents required typically include a compliance certificate to be delivered annually, with the certificate or report setting out the relevant information to enable determination of whether the SPTs have been met and what ESG margin adjustment will apply.

Sustainability reports, either from an independent third party (**13%**) or from the borrower (**74%**), are required to be delivered in **87%** of SLLs, compared with just **47%** in 2022. This is a positive development in terms of transparency as these reports are intended to provide lenders with more fulsome information, including the methodology as to how calculations have been made when assessing performance and any adjustments to the KPIs/SPTs.

In another beneficial trend, as mentioned above, the requirement for fully independent reports made a return in H1 2023, with **13%** of all SLLs requiring a sustainability report from an independent auditor. This requirement had not been seen in any SLLs in 2022 and in only **6%** of SLLs in 2021.



The positive developments in reporting and disclosure continued in the first half of 2023 with the requirement for an External Verifier to provide statements of verification or assurance as to the borrower's determination of SPTs in the SL Documentation increasing significantly to **88%** compared with **60%** in 2022.



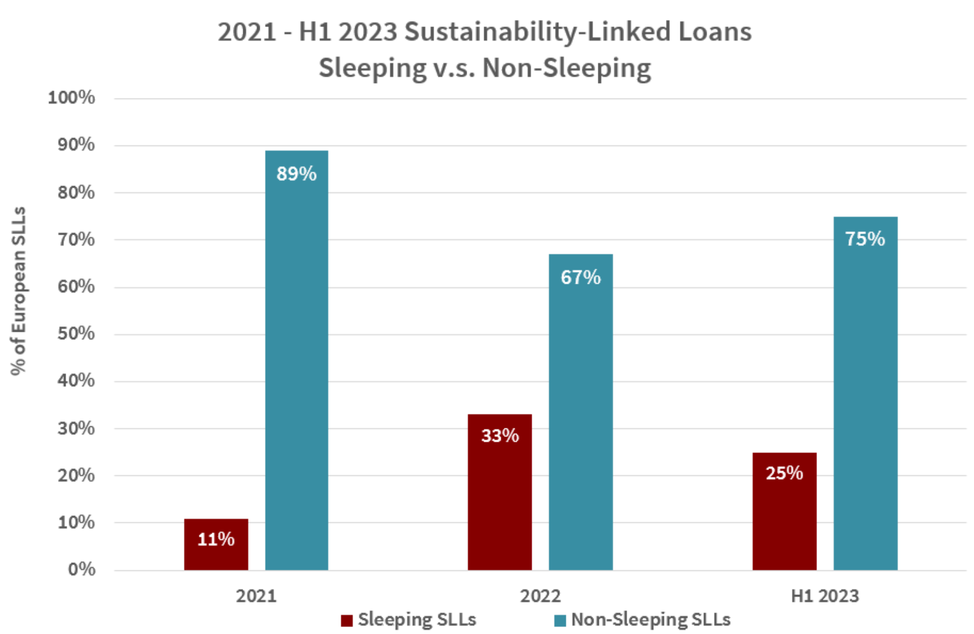
Other Documentary Considerations

Sleeping SLLs

As some parties might not have had sufficient time to agree the KPIs / SPTs at the time of loan origination, some deals postpone setting of all KPIs/SPTs to a later date. These SLLs known as "sleeping SLLs" (described in depth **HERE**) can then switch on the ESG Margin Ratchet during the lifetime of the loan provided consent is given by lenders, typically set at Majority Lender. As illustrated below, fewer borrowers in the first half of 2023 opted for sleeping SLLs compared with 2022. In 2022, sleeping SLLs were at an **all-time high**.

Sleeping SLLs could possibly have a positive impact on the ESG space. It could encourage more borrowers to opt for sustainability-linked financing where it would be difficult to complete all the necessary related work at the time the deal launches. It could also provide flexibility within the sustainability-financing instrument to allow parties to conduct further due diligence in establishing the SL Criteria that should apply.

However, care should be taken to ensure that when set in the future, such KPIs / SPTs are meaningful and ambitious (for example, it should not be set at a level that the borrower already knows it will achieve based on data available to it after loan origination) and the loan is not prematurely labeled as SLLs.



Amounts Saved: To Be Retained or Reinvested?

Some SLLs in 2021 required borrowers to invest the savings from application of the ESG Margin Ratchet into sustainability investments. We saw this requirement completely disappear in 2022. However, in H1 2023 it returned in **one SLL** where 100% of the amount saved from the reduction must be applied within a certain timeframe towards a sustainable investment.

Market, Regulation and Best Practices Overview

The integrity of the ESG market continues to be a critical topic, with regulators and other technical bodies joining forces to create a better framework for greater transparency, standardization and comparability of ESG data, guidance and regulatory requirements to help develop the sustainability-linked market and increase its credibility.

As emerged from the U.K. FCA's **investigation** on the functioning of the SLL market published in June 2023, the SLL market is not achieving its full potential. From a lender perspective, trust and transparency issues are the main obstacles. From a borrower perspective, concerns arise with respect to unwelcome scrutiny if targets are missed. Although missing a target is not necessarily a bad thing for the SLL market as it shows that at least some companies set their SPTs at challenging levels.

More prescriptive frameworks, uniform disclosures and independent monitoring and verification of targets could all help improve the SLL market integrity and reduce the threat of greenwashing accusations. Several steps, therefore, have been taken in the first half of 2023 to implement tools to help the development of the SLL market.

On June 26, the **IFRS Foundation's International Sustainability Standards Board**, or ISSB, the body working on integrating sustainability standards into corporate reporting, **issued** its **IFRS S1** and **IFRS S2** standards.

These standards are intended to ensure that companies provide sustainability-related information alongside their financial statements. Specifically, IFRS S1 provides a set of disclosure requirements designed to enable companies to communicate with investors about the sustainability-related risks and opportunities that could reasonably be expected to affect their cash flows, access to finance or cost of capital over the short, medium and long term. IFRS S2, by contrast, sets out specific disclosures regarding climate-related physical risks, transition risks and opportunities, and is designed to be used with IFRS S1.
While IFRS S1 and IFRS S2 are **effective** from 2024, the first reports of companies disclosing under these standards will be issued from June 2025. In the meantime, while the ISSB has launched a consultation on its future priorities, which closes on Sept. 1, jurisdictions around the globe, including the EU, are **encouraged** to integrate the ISSB standards into their own regulatory frameworks.

Continuing the efforts to achieve the objectives under the **European Green Deal** (which include no net GHG emissions by 2050 and economic growth decoupled from resource use), a **new package of measures** was announced to build on and strengthen the foundations of the EU sustainable finance framework. Overall, the package adds new activities to the **EU Taxonomy** and proposes new rules for ESG rating providers to increase transparency, ensure access to sustainable financing and make the sustainable finance framework easier to use. Among these measures, the European Commission is proposing a **regulation** to improve the reliability and transparency of ESG rating activities to protect investors and ensure market integrity. Notably, ESG rating providers will be required to be authorized and supervised by the European Securities and Markets Authority.

On top of this, a revised draft of the **European Sustainability Reporting Standards** was published and adopted in July 2023. The standards cover a full range of environmental, social and governance issues and provide information for investors to understand the sustainability impact of the companies in which they invest. They also align with global standards, including the ISSB standards to ensure interoperability between them and to prevent unnecessary double reporting by companies.

Following the update of the sustainability-linked loan principles in February 2023 (an in-depth overview of the principles is available **HERE**), the LMA published **draft provisions for SLLs**. As a starting point for drafting documents, the draft provisions seek to reflect current market practice and assist parties in the negotiation of the document, while omitting features that are commonly negotiated between the parties.

These developments show that market participants continue to work to find solutions to overcome the limitations present in the current SLL market. As the SLL market continues to grow and expand, we expect more solutions to be found and new issues to be addressed in the upcoming years.

Glossary

ESG Margin Ratchet: A margin adjustment mechanic built around the SL Criteria and the borrower's performance will result in either a decrease, or an increase, to the margin based on how it performs against these criteria.

ESG Rating: An overall ESG rating/score provided by a third-party ratings agency, with the baseline set at the ratings/score assigned on or around closing and against which the borrower's future performance is measured.

External Verifier: A borrower appointed qualified third party providing assurance on whether the SPTs have been met or, in the context of amendments related to the sustainability-linked provisions, reviewing the relevant amendments.

Hybrid Approach (described in depth **HERE**): A hybrid approach taking one of the following forms: (i) the margin ratchet is KPI-based, but with an external ESG score being required to ascertain one or more (but not all of) the KPIs or (ii) the documentation outlines a framework for use of either KPIs or an overall ESG Rating, with the borrower given the choice which to pursue.

KPI / SPT: One or more key performance indicators based on environmental, social or governance concerns ("KPI") with specified targets known as "Sustainability Performance Targets", or "SPT") that the borrower has developed and aims to achieve during the life of the loan

SL Criteria: The incorporation of ESG features into loans as a means to incentivize borrowers to improve their performance in selected ESG areas against pre-set criteria. This criteria can either be KPI / SPT based , ESG Rating based or a combination of both known as the Hybrid Approach.