MAYER | BROWN

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Looking Ahead | How ESG may affect refinancings and restructurings of Covid-era debt

As the focus on ESG issues intensifies in the financial markets, we have seen institutional investors demand more in these areas, in terms of both disclosures and concrete targets, from banks and funds. Meanwhile, emerging regulations, and reforms designed to help meet climate change targets and to enhance corporate governance, sustainability and environmental and social responsibility are underway. How will refinancings and restructurings of the significant amount of corporate debt coming out of COVID be affected by such winds of change?

1. Enhanced regulatory framework for disclosures could facilitate credit risk management.

Lenders and sponsors alike are increasingly taking ESG risks into account in assessing the overall condition, prospects and stability of a business. In addition to the financial institutions themselves being subject to more stringent disclosure requirements[1] (and hence having to "look deep" into their portfolios to ensure they make the required disclosures properly), there is a growing recognition that ESG issues can pose material risks to businesses and, as such, adversely affect their financial performance and credit quality.[2] From this perspective, the enhanced disclosure requirements are tools which could help lenders and sponsors manage ESG risks by (a) enhancing transparency of the challenges facing businesses (thus aiding credit risk assessment and monitoring, and providing early warning signs) and (b) making ESG-related due diligence a more efficient and less costly process.

In the UK, all large and medium-sized companies are already required under the IFRS or the UK GAAP to disclose in their annual accounts "material uncertainties" that could affect the company's ability to continue as a going concern, and various non-financial / ESG-related reporting requirements exist already. In March 2021, the UK government launched a consultation on its proposals for far-reaching reforms of the audit and corporate governance regimes, aimed at restoring trust in those areas.[3] The proposals include a new reporting requirement for directors of public interest entities to make an annual "resilience statement", setting out how directors are assessing the company's prospects and addressing challenges to its business model over the short, medium and long-term, including risks posed by climate change. The UK government is also seeking views on how company annual reports could include minimum reporting on supplier payment policies and practices. While mandatory reporting requirements may lead to additional compliance costs, they may be helpful for financial stakeholders for the reasons discussed above.

REGULATORY SPOTLIGHT:

In the EU:

- Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (the "Sustainable Finance Disclosure Regulation" or "SFDR") (effective from 10 March 2021) imposes new disclosure obligations on how asset managers integrate ESG factors into their risk processes.
- Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (the "Taxonomy Regulation") (expected to come into force by early 2022) will regulate how asset managers offering "environmentally sustainable" products should assess the extent to which an economic activity is "environmentally sustainable". In connection with this, the EBA has published an opinion on 1 March 2021 in which it recommends (among other things) a "green asset ratio" as a key performance indicator, and that credit institutions disclose their green asset ratio to show the extent to which the financing activities in their banking book (including loans and advances, debt securities and equity instruments) are aligned with the Taxonomy Regulation, the Paris Agreement and the UN SDGs. See our blog post "EBA Proposes Green Asset Ratio as KPI for Banks Under EU's Sustainable Disclosure Requirements", 3 March 2021.

Both initiatives are expected to lead to greater focus on due diligence and monitoring of companies from an ESG perspective by in-scope financial services sector firms in the EU.

Note that, as a result of Brexit, they do not automatically apply to UK firms but may still be relevant for them in the context of their products, services and activities in the EU market, and for any EU-based subsidiaries. The UK is expected to enact its own requirements for climate-related disclosures and taxonomy.

1 See box insert for example.

2 "Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions" published by the European Leveraged Finance Association and the Loan Market Association under the ESG Disclosure Initiative.

3 "Restoring trust in audit and corporate governance – Consultation on the government's proposal" published by the Department for Business, Energy & Industrial Strategy, March 2021.

2. Default of green loans and social loans will test documentation and market response.

Principles are being developed in the market for green loans and social loans, focusing on (among other things) restricting the use and management of proceeds for the projects being financed and regular reporting. It remains to be seen how lenders will deal with breaches and defaults in practice. Even if the relevant loan is of a modest amount, indirect consequences such as reputational damage and cross-default (if any) to the other debt of the borrower will need to be considered. Lenders will also need to carefully consider the impact of their response on their own ESG credentials.

3. Additional covenants to address material ESG risks is a space to watch.

Now that the link between ESG risks and credit quality is more established and better understood in the financial markets, an increasingly pertinent question will be whether there is sufficient covenant protection for lenders against ESG issues which could significantly and adversely affect credit quality.

Most of the sustainability-linked loans feature a margin ratchet linked to the ESG performance of the borrower against specified metrics, on which the borrower is required to report regularly, either based on internal assessment or external review. Failure to meet the targets or report typically do not constitute events of default. Such construct is intended to incentivise a borrower to make improvements in the relevant ESG criteria (and could be seen as "compensating" the lenders for the inherent higher credit risk linked to poorer ESG performance), but it does not provide a trigger for lenders to mitigate, at an earlier stage, the potential credit impact caused by ESG issues.

Typically, there is some degree of covenant protection with an ESG angle in a loan agreement, albeit the focus is on addressing "traditional" compliance risks (and, in leveraged or structured deals, risks which have a direct impact on security value):

- The LMA recommended form of facilities agreements for investment grade borrowers include general provisions such as the "compliance with laws" undertaking (subject to a materiality qualifier), the "no material adverse change" event of default, the information undertaking and representation regarding materially adverse litigations and other proceedings.
- The LMA recommended form of facilities agreements for leveraged acquisition finance transactions, in addition to the above clauses, include specific provisions on compliance with environmental laws, pensions, payment of tax and compliance with anti-corruption law, subject to materiality qualifiers where relevant.

More and better disclosures, as discussed above, will hopefully help lenders monitor material ESG risks, and we do not expect "mass codification" of ESG requirements into debt covenants. This is because businesses need a degree of operational flexibility and hair triggers could be counter-productive. Nevertheless, as lenders' institutional ESG policies and commitments evolve, targeted enhanced covenants and information undertakings on ESG matters is a space to watch.

REGULATORY SPOTLIGHT:

In its recent reports on the progress of the banking sector in understanding, analysing and measuring climate-related financial risks, the Basel Committee on Banking Supervision notes that traditional risk categories used by financial institutions and reflected in the Basel Framework can be used to capture climate-related financial risks and that it would work to map out the gaps in the current Basel framework in the near-term and, in the future, explore possible measures to address the gaps where relevant.[4] Clearly, methodologies and quantitative issues, among others, will need to be resolved before climate-related financial risks could be incorporated into bank regulatory requirements, but the Basel Committee's work indicates the direction of travel in risk assessment and control.

4 See further in our client alert "BCBS Issues Two Climate-Related Reports Highlighting Work Remaining", 15 April 2021.

4. ESG influence may (eventually) be seen in lenders' credit decisions in a distressed scenario.

More banks and other financial institutions have now made commitments about climate change targets for their loan portfolios, and the importance of ESG risk considerations in the credit decision process has gradually increased. Where a lender's credit assessment criteria and/or outcome in respect of existing facilities for a borrower have changed as a result of evolvement of that lender's ESG policies since original signing, that lender will need to decide how to address the mismatch as part of its on-going portfolio management.

The issue is more pressing if the relevant borrower has become financially distressed and is in need of additional liquidity, forbearance or equitisation of debt. How will the banks strike a balance between, on the one hand, the money already at risk and the impact of any write-off on their bottom line in the near term and, on the other hand, their commitment to move ESG considerations up their agenda and the need to mitigate against the ESG risks of such debt and investments in the long term? They will also need to be mindful of other regulatory obligations, for example, the requirement to "treat customers fairly".

5. Restructuring negotiations could be the next opportunity to embed ESG-positive changes.

As mentioned above, there is an increasing recognition of the link between ESG and credit risks. From this perspective, minimising credit loss from existing debt on the one hand, and promoting and upholding ESG considerations on the other, are not necessarily mutually exclusive. Debt restructuring could also serve as an opportunity for lenders to induce ESG-positive changes to align the borrower more closely with current credit requirements and risk assessments informed by ESG issues. The following could conceivably evolve from existing practices and typical terms in a restructuring context:

Corporate governance and diversity:	Corporate governance shortcomings have been found to be an issue in many recent large-scale corporate failures. It is not uncommon for lenders to require improvements in this area as a condition for supporting a borrower's debt restructuring. At present this could involve requiring the borrower to appoint one or more new independent non-executive directors with sector, product or restructuring expertise, and/or to mandate searches for new members of senior management. Given the focus on enhancing diversity in corporate leadership, will lenders look to encourage diversity considerations in such appointment and search process? In the UK, the Financial Conduct Authority is already considering whether to make diversity requirements a part of its premium listing rules, similar to the approach taken by NASDAQ in the US.[5] Diversity efforts across the business, financial and professional services sector more generally should, in turn, contribute to a more diverse pool of candidates at the senior level.
Business plan and financial model taking into account ESG risks:	Lenders' support for a debt restructuring is typically predicated on an acceptable business plan and financial model in order to assess the risks going forward. Where ESG risks could materially affect the business's performance, cashflow and value, and hence credit quality, well-advised lenders are likely to require these to be taken into account in the business plan and the modelling. For this purpose, it may be desirable to seek input from financial and legal advisers with specialist knowledge in the relevant ESG issues.
Capex and disposal programmes taking into account ESG factors:	Where a business plan is formulated taking into account ESG risks, it may result in consequential changes to the borrower's capital expenditure and disposal programmes. For example, will distressed borrowers (if any) in the energy sector be gradually incentivised to divest of assets in their portfolio which are "less clean"? Will such divestment targets become more important in order for lenders to obtain the necessary internal approval to proceed with the transaction?
Adjusting the MIP:	As part of the restructuring, remuneration packages of senior management may be re-negotiated. Whilst this is primarily a matter for the board and the shareholders / sponsors, lenders hold some sway where there is no residual equity value at the time of the restructuring negotiations. One would expect that management incentives should be designed to align with the new business plan and thereby reflect ESG considerations to the extent incorporated therein. Clearly, lenders are likely to have even more influence over this in the context of a debt-for-equity swap. The UK government's recent proposal, now under public consultation, to strengthen malus and clawback provisions within executive directors' remuneration arrangements[6] is relevant and the outcome of such consultation should be closely watched.
Use of excess cash and impact of defined benefit pension reforms:	Post-restructuring, a borrower is likely to be subject to tighter controls on how excess cash generated from the business could be used. Typically, the restructured debt terms require excess cash to be applied to pay down the debt, which (in cases involving a pension scheme deficit) may include further deficit reduction contributions. In the UK, it remains to be seen how the latest legislative reforms giving the Pensions Regulator broader power to call for contributions and prosecute offences in relation to acts or omissions which adversely affect a defined benefit pension scheme[7] will affect negotiations of restructuring terms and dividend policies. Another key development to watch is the UK government's consultation on its proposed reforms in relation to dividends and capital maintenance.[8]

5 See our blog post "UK Regulator to Prioritize Diversity and Inclusion for the Financial Services Industry", 22 March 2021.

6 See note 3.

7 For more discussion on this, see our alert "What Employers in Distress Need to Know: The Pensions Scheme Act 2021", 8 March 2021.

8 See note 3.

6. Due diligence and mitigation of ESG risks will be important in any credit bid or debt-for-equity swap.

ESG questionnaires and due diligence have become more common in M&A investment decisions and we expect similar concerns to apply to lenders considering whether to take over the ownership of a distressed borrower or business. The biggest challenges in a distressed scenario are likely to be (a) the time pressure and (b) the limited options to structure around material ESG risks. Nevertheless, given the enhanced disclosure requirements, potential liabilities and reputational damage, it is crucial for lenders to carry out due diligence in order to identify any material ESG risk.

It should also be noted that such risk is not limited to compliance in the jurisdiction in which the parent company or the borrower is incorporated – for example, recent decisions from the UK Supreme Court make clear the risk of litigation to, and potential liabilities of, a parent company in respect of the actions of its subsidiary, including in relation to ESG related harms such as environmental damage[9].

Given the tight time frame and the implications of the process and outcome of such exercise on the broader restructuring, it may be worth engaging financial, technical and legal advisers with specialist knowledge in ESG issues and regulatory requirements to advise on the appropriate scope of and undertake the due diligence work, as well as preparing an options analysis which will feed into lenders' strategy in the restructuring discussions. It would also be interesting to see if, in due course, any insurance products will be developed to mitigate ESG risks (similar to litigation insurance or title insurance in an acquisition scenario).

7. Specialist debt purchasers may emerge if investment opportunities arise from ESG issues of distressed borrowers.

While private equity fundraising and investments with an ESG focus, as well as distressed debt funds, have grown considerably respectively, it remains to be seen whether fund managers will see specific investment opportunities in the debt of distressed borrowers with ESG issues. For example, in the future, will there be appetite among funds to support the turnaround of businesses with underlying or significant ESG issues (and thus a depressed price for their debt in the secondary market), with an eye on their potential recovery (and hence an upside for the lenders or loan-to-own investors), once they are restructured and ESG issues are properly addressed?

9 See our alert "UK Supreme Court Clarifies Parent Company Liability for ESG-Related Harms Caused by Foreign Subsidiaries", 2 March 2021.

As businesses emerge from COVID with a significant load of corporate debt, ESG considerations look set to become part of the "normal" operating model of lenders, borrowers and sponsors alike. We therefore think it is timely to take stock of where we are and in this piece we consider how ESG issues could affect refinancings and restructurings going forward.

We would be interested to hear the views of our clients and other market practitioners. Join the discussion on the Mayer Brown Eye on ESG Blog. You can also find more updates and articles to keep you up to speed of the transition to sustainable business and finance there.

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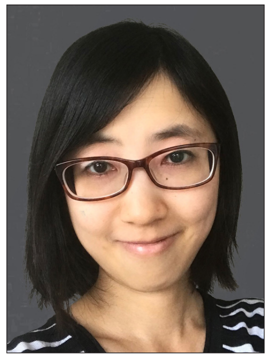

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