Principles for Responsible Investment

ESG INCORPORATION IN DIRECT LENDING

A GUIDE FOR PRIVATE DEBT INVESTORS

SEPTEMBER 2023

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1 We will incorporate ESG issues into investment analysis and decision-making processes.

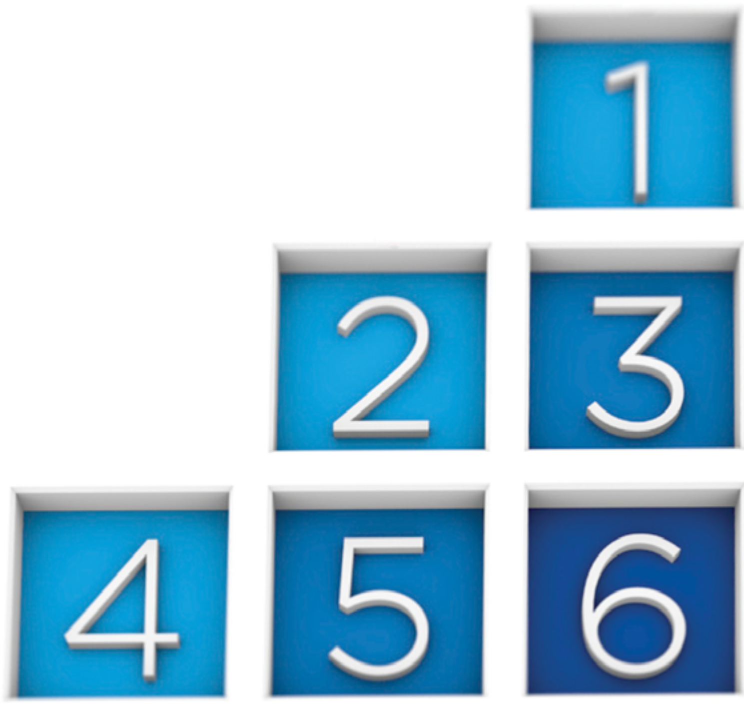
2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

CONTENTS

ACKNOWLEDGEMENTS

The PRI would like to thank the Private Debt Advisory Committee (PDAC) members for their guidance and feedback on this report. As at August 2023, members included Sebastian Schroff (Allianz Group), Allison Binns (Angelo Gordon), Marcin Lenart (APG Asset Management N.V.), Michael Kashani (Apollo Global Management, Inc.), Nathan Brown (Arcmont Asset Management), Adam Heltzer (Ares Management Corp and PDAC Committee Chair), Caoimhe Bain (Hayfin Capital Management LLP), Faith Rosenfeld (HPS Investment Partners, LLC), William Needham (Kohlberg Kravis Roberts & Co. L.P.), Sanjay Mistry (Pension Protection Fund), Catherine Isabelle (Public Sector Pension Investment Board), Cathy DiSalvo (California State Teachers' Retirement System) and Vincent Lemaitre (Tikehau Capital).

The paper also draws from other market participants, including Aida Giniyatullina (NN Group), Travis Antoniono (California Public Employees' Retirement System), Alex Owen (Brunel Pension Partnership), Laura Lincoln (Utah Retirement Systems), Marcelo Jordan (World Bank), Katie Cotterell (Bridgepoint Group plc), Keren Raz (APG Asset Management US Inc) and Anand Rajagopal (Phoenix Group). This group was interviewed about their companies' ESG incorporation practices by CRISIL, a consultant appointed by the PRI. CRISIL also contributed to desk-based research and to formulating the online survey, the results of which fed into this paper.

The opinions, recommendations, findings and conclusions in the report are those of the PRI alone and do not necessarily represent the views of the contributors.

ABOUT THIS PAPER

This paper builds on the PRI's 2019 report, Spotlight on Responsible Investment in Private Debt, and develops an analysis based on interviews with 20 private debt market practitioners and a survey of 85 market participants. The survey and interviews were done between February and May 2023. The PRI selected CRISIL to help design, execute and deliver the survey and interviews. CRISIL delivers bespoke ESG integration services and solutions to a broad range of capital market participants. The PRI had extensive help in the design and analysis of this report from the PRI's Private Debt Advisory Committee (PDAC). The online survey included private debt investors, especially those involved in direct lending, who act as general partners (GPs) and / or limited partners (LPs). The survey's multiple choice questions covered five areas:

- Collection of environmental, social and governance (ESG) data
- Consideration of climate-related risks in decision-making
- Collaboration with peers and private equity sponsors
- Sustainability-linked loans (SLLs)
- Limited partners' engagement with general partners and borrowers

Of the 85 respondents, 78% were GPs and 22% were LPs. The LPs and GPs were from Europe and North America. The majority of AUM from these respondents was invested in North America and Europe and the most frequent AUM size was less than US$50bn for both LPs and GPs. The 20 interviewees are listed in the acknowledgements and were largely selected from the PDAC. This report is intended to complement the PRI's existing work on private debt and responsible investment, as shown to the right.

ESG Integrated Disclosure Project: An industry initiative to improve transparency and accountability by bringing together leading lenders in the private credit and syndicated loan markets.

Private Credit-Private Equity ESG Factor Map: The map streamlines the ESG information shared during the investment process to facilitate collaboration between sponsors, co-investors and lenders and integrate existing ESG standards and frameworks.

Spotlight on Responsible Investment in Private Debt: This 2019 guide provides a framework for incorporating ESG factors into the investment process for private debt. It covers data, investment decisions and engagement.

ESG in Private Debt podcast: Adam Heltzer (Ares Management) and Faith Rosenfeld (HPS Investment Partners) talk to the PRI about how private debt investors are incorporating ESG into their investment practices.

Responsible investment DDQ for private debt investors: Indirect investors (i.e., LPs or asset owners) can use this ESG due diligence questionnaire (DDQ) when assessing potential private debt managers.

FOREWORDS

PRINCIPLES FOR RESPONSIBLE INVESTMENT

Private debt investors have made significant inroads in their analysis of ESG factors since the PRI's 2019 report on this market. Incorporation of ESG factors in the due diligence process is now widespread across the industry. Engagement with investees, which was largely unheard of just four years ago, is increasingly used by private debt GPs.

The private debt market has also given rise to promising innovations. For example, GPs and LPs have moved to link sustainability targets with interest rates through sustainability-linked loans, providing a unique set of tools to encourage better sustainability outcomes. Innovation also brings risks. Investors must take care in how they structure these instruments. A failure to outline challenging targets or standardise practices may result in allegations of greenwashing. Reporting must be meaningful and subject to scrutiny and verification.

We hope the progress achieved in this market will support improved sustainability outcomes in the real economy – something that is increasingly central to regulators' and clients' requirements of investors.

I would like to thank our signatories for participating in the survey and interviews, on which the report findings are based. Signatory enthusiasm for sharing practices and issues is critical to their success. We would also like to thank CRISIL for helping to deliver a report that will hopefully develop market thinking and improve practice among private debt investors, investment consultants and asset owners who allocate to this asset class.

David Atkin
CEO, Principles for Responsible Investment

ARES MANAGEMENT CORP.

When the PRI published its first "spotlight" on responsible investment in private debt in 2019, there was a sense of untapped potential for ESG integration in the asset class. Historically deemphasized relative to private equity as a channel for responsible investment, private debt investors used the spotlight to offer evidence that ESG integration was indeed relevant for lenders.

In the years since, we've observed significant growth in the size, reach, and influence of the private debt market, and with it the increasing uptake of ESG integration practices described in this report. Private debt AUM has nearly quintupled since 2008 and currently stands close to $1.4tn with an anticipated CAGR of 11% through 2027. This market growth has compelled general and limited partners alike to take an even closer look at responsible investment practices in private debt, to further enhance credit risk analysis.

After the great financial crisis of 2008-2009 and large wave of bank consolidation, many of the world's largest banks were compelled to lower their risk appetites, constraining access to capital for many small- and medium-sized businesses. Private debt managers filled this need, often providing speed, flexibility and customization that turned many first-time borrowers into repeat customers. Additional turbulence in the banking sector in 2023 may further reinforce the role of private lenders as a vital source of capital for many segments of the economy in the years ahead.

This evolution of ESG integration in private debt is no accident. The key themes in the report – ESG data, sustainability-linked loans, and climate risks and targets,– emphasize that private lenders, sponsors and portfolio companies are critical collaborators in the effort of ESG integration in private debt. In this effort, management teams of small- and medium-sized companies are increasingly looking to their private lenders to help accelerate the maturity of their company's sustainability programs with a key focus on integration into business strategy. Together, these components have the potential to enhance value creation, better enable risk mitigation and achieve sustainability outcomes.

On behalf of my fellow committee members, we hope this document helps a range of market practitioners understand both the current state of best practice and anticipate key growth areas in the years ahead. While this 2023 report reminds us of how far the industry has advanced since the 2019 edition, we know there is still much to accomplish. Close collaboration amongst lenders, borrowers, limited partners, private equity sponsors and service providers will be critical to unlocking this next wave of potential.

Adam Heltzer
Head of ESG, Ares Management Corp.
Chair, Private Debt Advisory Committee

EXECUTIVE SUMMARY

Much has happened in the responsible investment landscape since the PRI's first report on private debt in 2019. Assets under management in ESG funds have grown rapidly; key markets have stepped up regulation; there have been two crucial Conferences of the Parties on climate and biodiversity; and the tone of political debate around ESG has sharpened in some markets. These changes have raised the bar in every asset class for investment managers and asset owners committed to responsible investment.

When we developed a responsible investment framework for private debt investors in 2019, investors told us they struggled to incorporate ESG factors into investment decision-making or engagement with borrowers in private debt. In early 2023, we undertook research to map current market practices and test how the market has changed.

The research shows that private debt LPs and GPs have made great strides in integrating ESG-related risks into decision-making. The majority of the industry now incorporates ESG factors in some way and many industry participants are collaborating to improve data collection and reporting. This paper shares the findings from our research and proceeds as follows:

MARKET OVERVIEW

This section gauges the growth in private debt transactions and reviews four factors driving the integration of ESG factors into investment decision-making. It highlights that investor demand and regulatory issues are the key considerations for LPs and GPs in the private debt market.

INCORPORATING ESG FACTORS INTO DECISION-MAKING

Data

Collection of ESG data has become widespread, chiefly to inform due diligence. The survey highlights issues relating to data quality, reliability and verification in the private debt market. This section looks in detail at how data is collected and outlines some ideas for improving access to data.

Engagement and sustainability-linked loans

Engagement is viewed as challenging for private debt investors because their ownership rights differ from those in other asset classes. In this market, efforts to encourage improved sustainability outcomes have taken the form of sustainability-linked loans (SLLs), which link sustainability targets or performance indicators with the interest rates paid by borrowers.

Private lender and private equity sponsor collaboration

The survey shows that collaboration among private lenders – and with private equity sponsors – is the exception rather than the norm. Yet LPs are strongly in favour of collaboration to promote standardisation in data collection to improve sustainability outcomes of borrowers.

Climate-related risks and targets

The survey found improved reporting against the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations, however it also highlighted barriers to target-setting and scenario analysis. Broadly, the survey indicates that LPs' expectations on aligning with net-zero ambitions are rising and GPs must develop processes to incorporate similar principles in the private debt asset class.

Excerpts from interviews with signatories are included throughout the report.

TAKING ACTION

The earlier report provided a framework for incorporating ESG factors in each phase of the investment process: origination / pre-assessment, due diligence / investment approval, and holding period. The feedback from the survey and interviews have allowed us to provide updates to leading practices in data collection, engagement and SLLs and collaboration during each phase of the investment process.

Figure 1: Opportunities to improve ESG incorporation throughout the investment cycle

	Data	Engagement and SLLs	Collaboration
Origination / pre- assessment	**Loan or deal documentation** Develop standardised ESG clauses for loan documentation. Identify and agree ESG ratchets pre-transaction. Develop methodologies for standard KPIs and incentives.	**Develop group response to climate change** Identify key drivers and objectives. Review peer group practices and external guidelines. **Develop a portfolio response to climate change** Develop sector-specific approaches for different borrowers.	**Private equity sponsors** Develop collaborative relationships between private lenders and private equity sponsors, especially on climate-related risks and engagements.
Due diligence / investment approval	**Pooling resources** Use relationships with market participants to leverage resources and expertise during due diligence. **Climate data reporting** Introduce climate metrics for borrowers and incorporate into LP reporting.	**Sustainability-linked loans** Aim to improve guidance, training, verification around the use of SLLs. Clearly define, document and verify interest rate ratchets tied to multi-year ESG KPIs.	**Improve consistency** Develop and establish consistent practices for investment due diligence. **Private lender relationships** Determine common ESG data collection or SLL targets to collaborate on to ensure consistency.
Holding period	**Standardised ESG reporting** Actively support standardisation of data collection and monitoring of borrowers.	**Standardising SLLs and / or KPIs** Define and document interest rate ratchets tied to ESG KPIs over multi-year period. Undertake annual verification of KPIs and restatement if material acquisitions occur. Extend KPIs beyond data disclosure to include cost savings connected to ESG initiatives and outcomes. Develop external, independent and verifiable sources of information to monitor if targets have been met.	**Private equity sponsors** Increase collaboration with private equity sponsors on ESG data and SLL oversight progress. **Industry engagement** Develop and commit to collaborative initiatives with borrowers and private equity sponsors around ESG integration frameworks and climate and data collection initiatives.

MARKET OVERVIEW

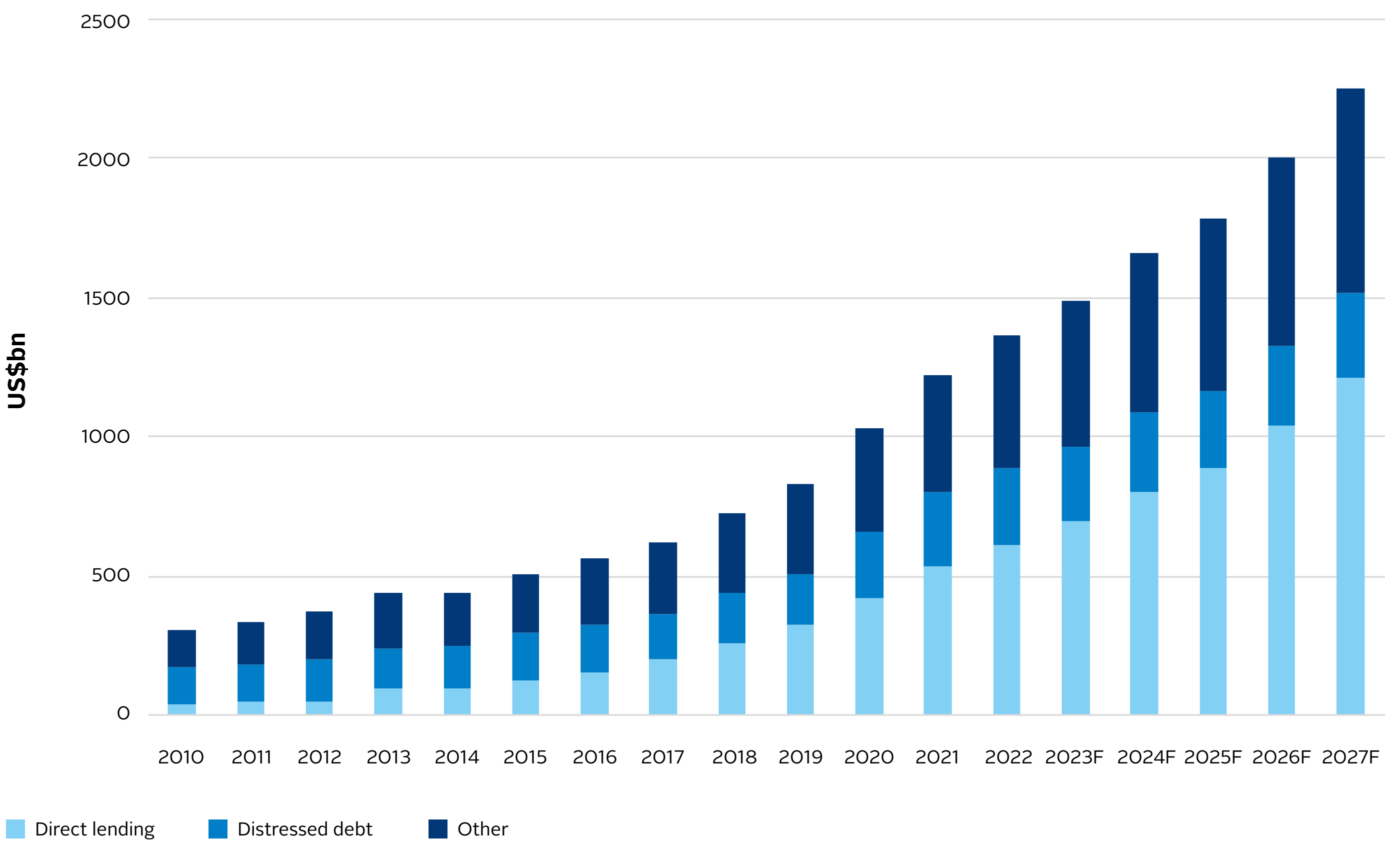
KEY MESSAGES

- The private debt market has grown at 13% CAGR over the past decade, with direct lending showing the most growth.
- Of four traditional drivers of responsible investment, investor demand and changing regulations have been most instrumental.

GROWTH OF PRIVATE DEBT MARKET

Private debt transactions have become an increasingly common source of funding over the past decade. Data provider Preqin Pro estimates growth of 13% CAGR over that period to a market size of US$1.4 trillion as of 2023. Within this market segment, direct lending has gained increasing market share, largely due to constraints on bank lending since the 2008 global financial crisis.

Figure 2: Global private debt AUM by strategy (US$bn).



Source: Preqin Pro, June 2023

RESPONSIBLE INVESTMENT DRIVERS

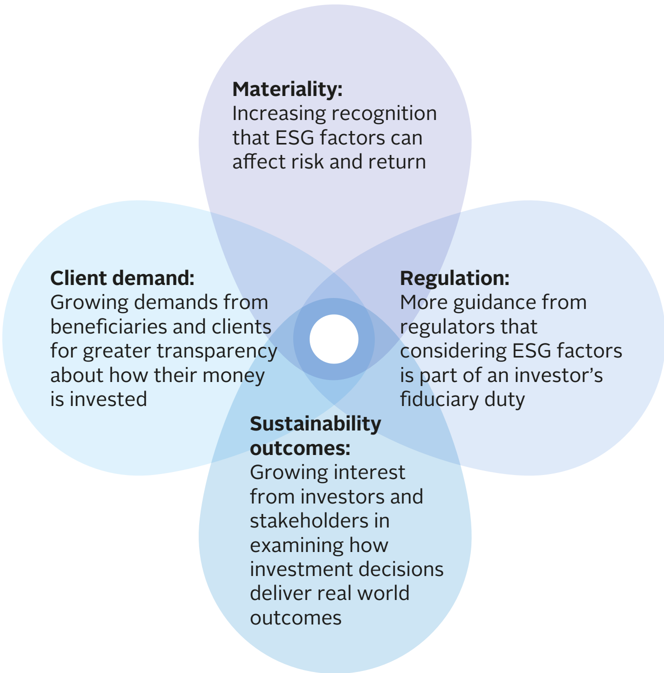
Since the 2019 publication of the PRI's private debt paper, interest in responsible investment has grown significantly. The PRI has identified four key factors: growing investor demand, changing regulation, better understanding of the materiality of some ESG issues and, more recently, an increased focus from investors and asset owners on sustainability outcomes.

These factors are also evident in the private debt market, although the data indicates that investor demand and regulation have been more significant in the investment processes of LPs and GPs. As an example of changing client demand, 42% of LPs require GPs to provide annual ESG-related disclosures and 31% request information on a more frequent basis.

Our signatories have told us that private debt GPs often struggle with applying regulations, given the rules are often framed and written primarily with listed equity investors in mind. However, it is clear SFDR Articles 8 and 9 have had a major role in driving the uptake of responsible investment in private debt markets. Regulation in this area is changing and evolving, which means private debt investors will have to pay increasing attention to new requirements.

The PRI's analysis of reporting data[1] shows that engaging with investee businesses or assets is a core practice for asset owners and managers when implementing a responsible investment policy. However, the survey and interviews showed that engagement practices in private debt are at an earlier stage of development than for equities. While the ability of lenders to influence borrowers' ESG practices is different from equity investors, engagement by private debt lenders, and within alternative assets more generally, can be important and leverage can change over time. The survey and interviews showed that product innovation in private debt around sustainability-linked loans (SLLs), including ratchets and covenants, could play an interesting role in promoting better outcomes.

Figure 3: Key drivers of ESG integration



Source: ESG integration in listed equity: A technical guide

1 PRI (July 2022), Inside PRI data: asset owner action

INCORPORATING ESG FACTORS INTO DECISION-MAKING

KEY MESSAGES

Data

- Incorporating ESG factors in the due diligence process is widespread across the private debt industry.
- Access to relevant data remains a challenge.
- Signatories use a variety of in-house approaches to collect data, supported by numerous industry templates.

Engagement and sustainability-linked loans

- In private debt, engagement occurs most often at the pre-deal stage, with the goal of understanding how borrowers are managing ESG-related risk.
- LPs and GPs see SLLs as a valuable tool in promoting real-world outcomes. Areas for development include verification, setting targets and reporting progress.

Private lender and private equity sponsor collaboration

- Collaboration among private lenders – and with private equity sponsors – is the exception rather than the norm, however GPs are keen to promote collaboration between key participants.

Climate-related risks and targets

- LPs and GPs have made significant strides in managing climate-related risks, including increased adoption of TCFD requirements and the introduction of new climate commitments.

Private debt investors are increasingly incorporating ESG factors into their investment process. The survey found the most common ways of incorporating ESG is through pre-investment screens based on an exclusion policy and the collection of data on ESG factors to inform investment decisions and analysis. ESG committees are also increasingly commonplace and play a key role in pre-investment analysis and discussion of material ESG risks. The survey results show that, for direct lending transactions, 94% of GPs use a defined ESG due diligence process for borrowers.

While these developments are all promising, the survey also showed that the private debt market lags other asset classes in a number of areas. The survey and interviews focus on three key areas (data, engagement and collaboration) that have seen significant progress but also offer untapped opportunities for progress.

DATA

Collection of ESG-related data by private debt lenders is now widespread, with the survey results showing that 82% of GPs collect ESG data as part of their direct lending. Roughly half of respondents stated that data collection was undertaken for both mainstream and sustainability funds.

Gathering relevant ESG information to inform due diligence is the main driver for ESG data collection in private debt, which provides an interesting contrast to listed equities, where regulatory compliance is a primary driver.[2]

Interest from LPs also promotes increased ESG data collection and monitoring, with three-quarters of LP survey respondents encouraging GPs to interact with borrowers to collect data for both mainstream and sustainability funds. Interviews with a selection of LPs highlighted that the pressure to collect and collate relevant information on ESG factors is only likely to increase.

2 PRI (April 2023), ESG integration in listed equity: A technical guide

DATA COLLECTION

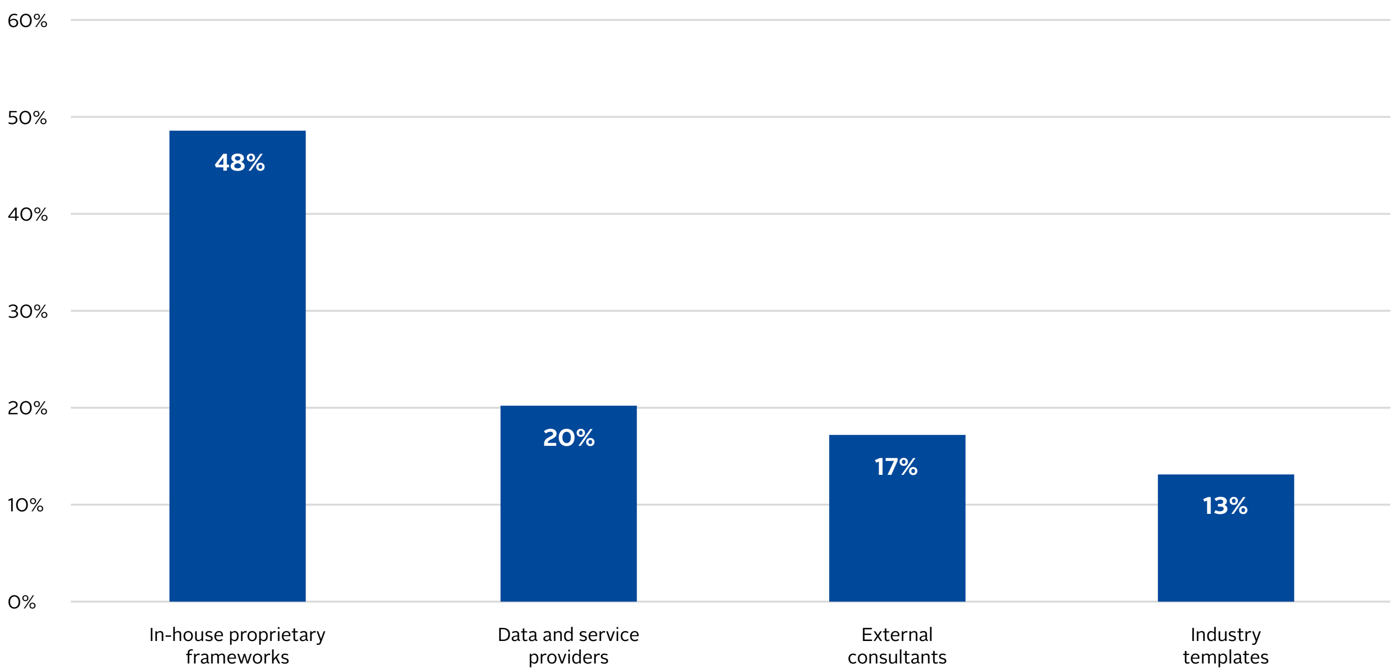
Nearly two-thirds of LPs believe that assessing ESG risks in the due diligence report is significant for direct lending deals. Some LPs have also developed and implemented their own due diligence process and checklist to assess the ESG policies and integration undertaken by GPs. As many as 84% of LPs agreed they depend on GPs for the data and discuss it and other ESG issues at annual (57%) or quarterly (20%) meetings.

More than half of GP respondents collect ESG data during the pre-deal due diligence phase to identify material ESG-related risks. Figure 4 highlights the diverse approaches used by GPs to collect ESG data from borrowers, with 48% of GPs using in-house proprietary frameworks employing pre-set questionnaires and negative screening lists. These frameworks depend heavily on borrower input, with the result that borrowers report they often answer a range of questions from different lenders that largely seek similar information.

Industry templates are most frequently based on the International Financial Reporting Standards (IFRS) and / or the Sustainability Accounting Standards Board. Popular templates include:

- ESG Fact Sheets from the European Leveraged Finance Association guide investors, borrowers, and other market participants on how to incorporate ESG factors into decision-making processes in specific sectors.
- The ESG Integrated Disclosure Project aims to support businesses with consistent ESG-focused disclosures when seeking financing in private credit and syndicated loan transactions.
- The ESG Data Convergence Initiative aims to simplify and standardise the process of collecting and reporting ESG data in private equity transactions. The initiative covers greenhouse gas footprints, labour practices, and governance structure.

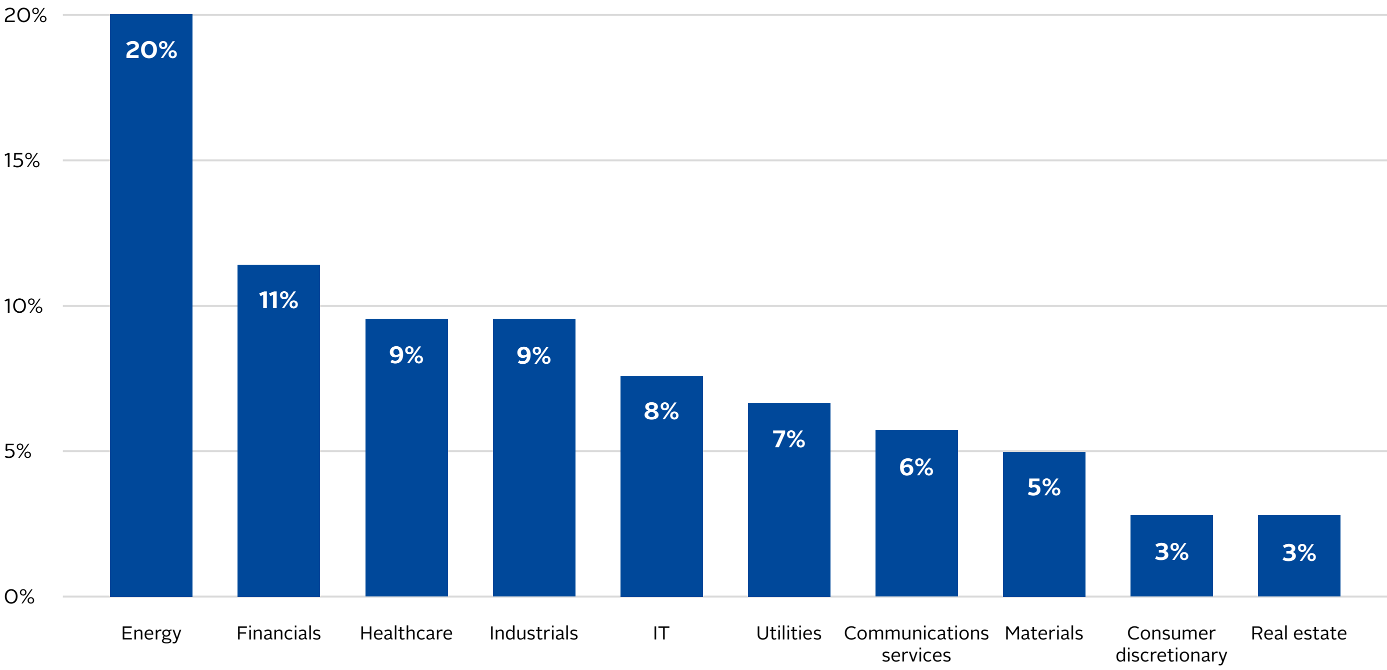
Figure 4: Ways GPs collect ESG data



Source: PRI Survey – ESG Incorporation in Direct Lending

The survey found that the quality of ESG data disclosed by borrowers varied between sectors, with the energy sector best in class.

Figure 5: Quality of data varies by sector



Source: PRI Survey – ESG Incorporation in Direct Lending

> "(Due diligence) ... involves sending out a due diligence questionnaire and evaluating the maturity of their ESG processes... Additionally, we offer recommendations to support their ESG engagement efforts. We also include ESG requirements in the side letters with managers, which includes the obligation to report to us on their ESG initiatives."
>
> LP, Europe

The type of data collected also varied. For example, a large majority (87%) of GPs regularly monitored ESG incidents as a key metric. This is done most frequently (approximately one-third of GPs) using borrower engagements, although GPs also employed questionnaires, direct reporting, direct dialogue with sponsors and annual reports. As with other asset classes, third-party data providers (28%) were another widely used source of ESG data on incidents and other metrics.

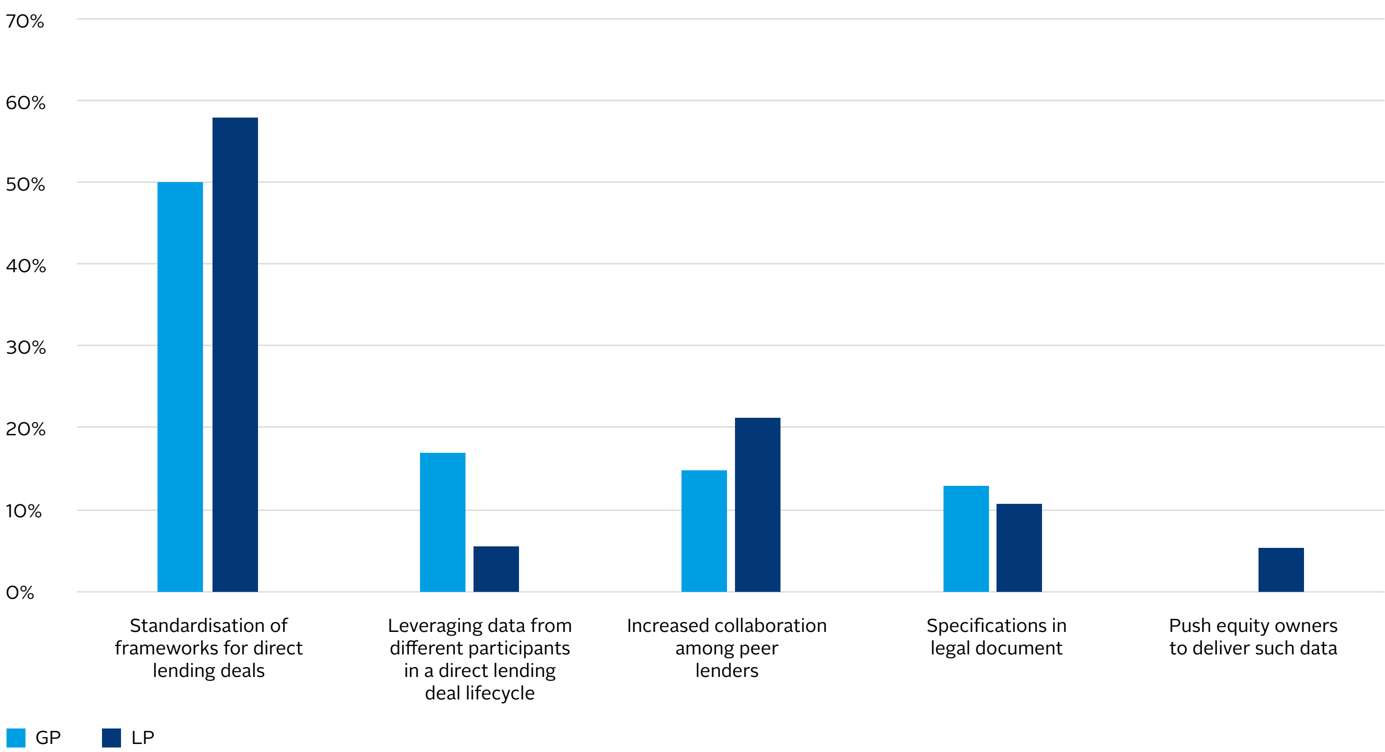
GPs also monitored progress towards any ESG targets they set for borrowers. Of the 41% of GPs who set such targets, a large majority (64%) reviewed progress annually. The interviews with GPs showed that these targets most commonly cover issues such as reducing greenhouse gas emissions and addressing diversity, equity and inclusion.

The survey and interviews highlighted that providing a standard framework to collect ESG data for the direct lending market was a clear priority for both GPs and LPs, with the goal of enabling the collection and monitoring of higher quality data.

"The framework of KPIs is heavily aligned with the ESG Data Convergence Initiative (EDCI). We have a few additional KPIs on transition targets because we have a climate strategy with specific climate targets that we've set for ourselves for 2026. We also added a few metrics on cybersecurity, business ethics, and corporate governance. It's mainly 85-90% aligned with the EDCI framework, and we collect those KPIs with our GPs on an annual basis."

LP, North America

Figure 6: Preferred options for improving ESG data collection: GPs and LPs



Source: PRI Survey – ESG Incorporation in Direct Lending

CHALLENGES

Despite real progress since our last report in 2019, significant challenges remain in data collection. Across asset classes, PRI signatories consistently highlight issues relating to data quality, reliability and verification as hurdles when assessing the relevance of ESG factors to investment decisions and portfolio construction. Though these issues arise across all asset classes, the survey highlighted specific challenges faced by GPs and LPs investing in private debt, including borrowers' limited awareness of ESG issues or data disclosure (22%) and an absence of standardised disclosures (32%) (see Figure 7). In addition, 65% of GPs report that they do not validate the accuracy of ESG data.

Given the smaller issuer size and lack of disclosure and transparency, the benefits of standardising ESG data collection in private debt would be significant.

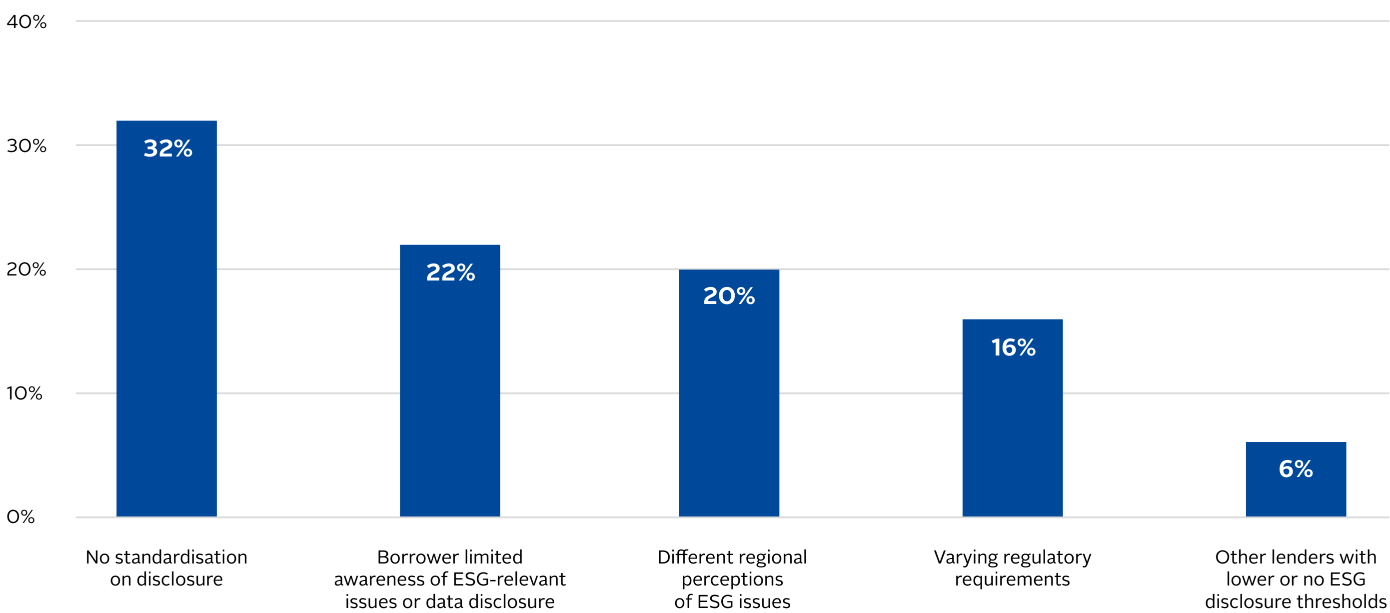
Additional challenges in this asset class include:

- **Scale:** Private lenders often work with small- and medium-sized companies that lack the resources needed to comply with GPs' escalating demands.
- **Timing:** Private debt lenders are typically introduced to a deal later in the investment process than the private equity sponsor. In some circumstances, this may limit the ability to undertake full due diligence prior to the deal closing.
- **Validation:** An inability to validate ESG data makes it difficult for lenders to ensure consistency, comparability and quality.

"While we make efforts to collect data, this doesn't guarantee complete data coverage ... we expect this to improve in the coming years, with greater awareness from borrowers and PE sponsors and greater regulatory demands."

LP, Europe

Figure 7: Challenges in improving ESG data accuracy



Source: PRI Survey – ESG Incorporation in Direct Lending

ENGAGEMENT AND SUSTAINABILITY-LINKED LOANS

In much of the work the PRI has undertaken with signatories, engagement has been identified as the primary mechanism for implementing ESG targets and objectives across portfolios. The PRI has undertaken a series of work programmes on engagement and stewardship that cover voting, policy engagement and collaboration. However, this work has not extended to the private debt market, where there is little information or guidance available on how to engage.

The survey highlighted that private debt lenders engage with borrowers primarily to understand how they are managing ESG-related risks.

The PRI defines stewardship as:

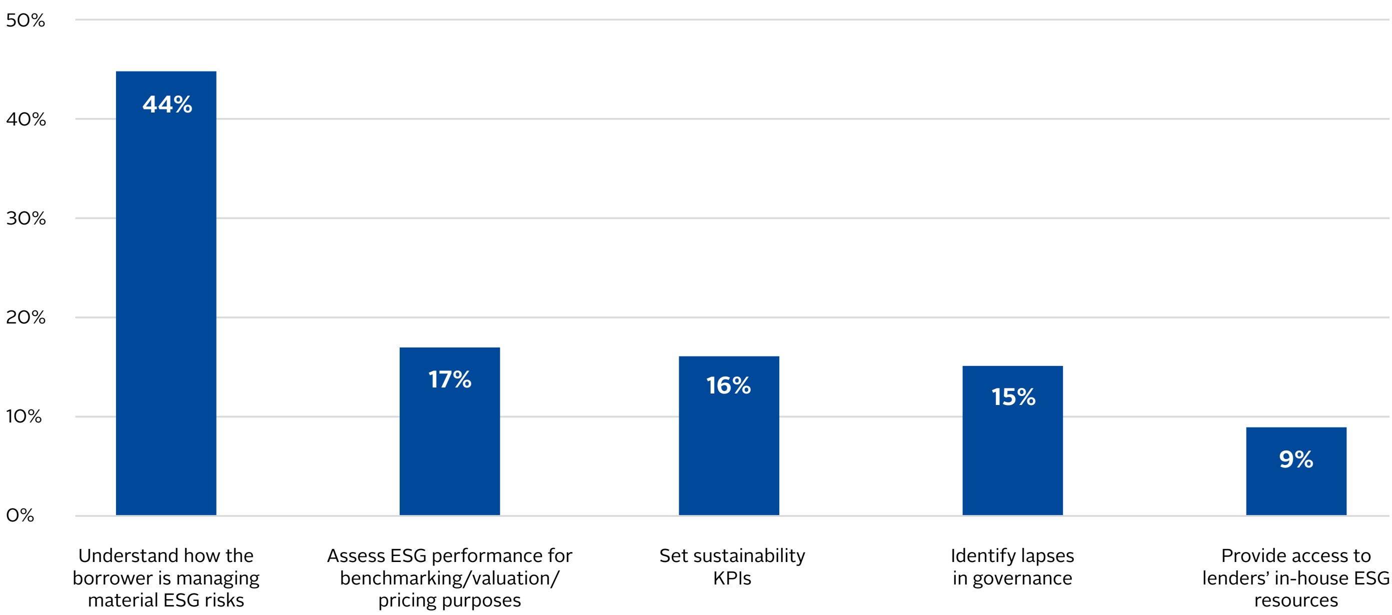
"The use of influence by institutional investors to maximise overall long-term value, including the value of common economic, social and environmental assets, on which returns and client and beneficiary interests depend."

The PRI defines engagement as:

"Interactions and dialogue conducted between an investor, or their service provider and a current or potential investee (e.g., company), or a non-issuer stakeholder (e.g., an external investment manager or policy maker) to improve practice on an ESG factor, make progress on sustainability outcomes, or improve public disclosure. In private markets, engagement also refers to investors' direct control over and dialogue with management teams and / or Board of portfolio companies and/or real assets."

Reporting Framework glossary

Figure 8: Why investment teams engage on ESG topics



Source: PRI Survey – ESG Incorporation in Direct Lending

The pre-deal stage is the most active engagement period, with a large majority of GPs (85%) stating that this allows investment teams to ensure compliance with portfolio exclusion policies and to identify ESG-related risks. Successful engagement heavily relied on the willingness of the borrower entity's management to engage or respond. The position as lender rather than owner reduced the potential to encourage change or collect relevant data – an important difference from private equity investors.

Interviews stressed that successful engagement often required new tools or processes, including training and raising awareness. Engagement also relies on effective collaboration with borrowers' management, private equity sponsors and between LPs and GPs.

As in all asset classes, climate-related risks and outcomes have moved to the forefront in engagement efforts. Most GPs plan to discuss climate-related risks with borrowers through ad hoc or more systematic engagements.

While private debt lenders face engagement obstacles, the interviews and survey highlighted that they also have unique tools to encourage better ESG outcomes. Sustainability-linked loans (SLLs) are financial tools that link a portion of the interest rate to the borrower's ability to meet a pre-selected sustainability target. As such, they provide an opportunity for investors to incentivise investee businesses using a mechanism that is not available in other asset classes. Three-quarters of LP survey respondents viewed SLLs as a good mechanism to achieve better sustainability outcomes.

The market for SLLs has grown since our 2019 report with the introduction of new products and standards.[3] One such standard is the Loan Syndications and Trading Association's Sustainability-Linked Loan Principles, which are based around five core components: selection of KPIs; calibration of performance targets; loan characteristics; reporting; and verification. Other resources are available from France Invest, the European Investment Bank and the International Finance Corporation.

"I can think of at least one example that is ongoing currently with one of our private debt portfolio companies where we are helping them think through how to do a materiality assessment, which will then inform their own sustainability strategy or program that they are having in-house."

GP, North America

"We are likely going to invite all of our private debt companies to something we call the Climate Action Education Series, which is going to be quarterly webinars on various topics related to climate."

GP, North America

"We have an SLL Council, and we are also trying to scale this in our real estate debt, infrastructure debt, and private equity businesses."

GP, North America

"They have anywhere from a five to 20 basis point discount linked to some ESG KPIs. So, it started in Europe but it's being rolled out across global platforms in the US as well."

LP, North America

3 White & Case (Dec 2021), 2021: The Year of the Sustainability-Linked Loan

Most borrowers seem to be largely receptive to including sustainability measures within loan documentation. Where SLLs were issued and offered, almost 48% of borrowers accepted the offering. LPs are also supportive, with 53% having had discussions with GPs to include SLLs in direct lending practices and 58% believing SLLs enhance the structure of a transaction.

However, the market is still in early stages of development, with two-thirds of GP respondents stating they do not have SLLs as part of their direct lending portfolios and only 21% reporting having SLLs in their mainstream funds. Although GPs agreed that SLLs have the potential to become a more significant financial tool, the interviews highlighted a range of reasons for this low uptake:

- **Cost of verification:** Only 18% of GPs report using third parties when validating data from borrowers and verifying whether borrowers' KPI targets are relevant, partly due to the difficulty of obtaining reliable data.
- **Data validation:** As SLLs are a fairly new product, the lack of relevant data remains a hurdle; 23% of GPs said that they do not conduct any validation of KPI performance. However, other GPs address this problem by using a range of sources to measure KPI compliance.
- **Measuring outcomes:** A large majority of LPs (84%) struggled to introduce mechanisms or frameworks to measure the impact or outcome generated by investing in SLLs.

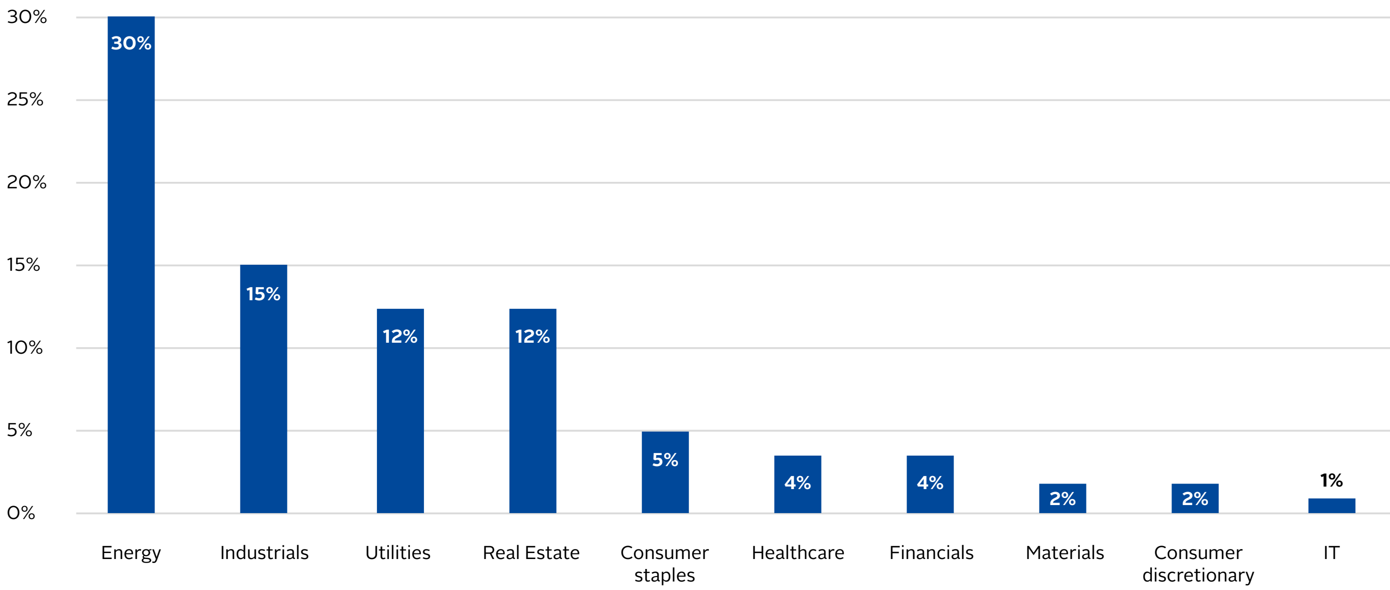
The survey and the interviews listed a series of actions that are required to develop the SLL market. Primary among these was capacity-building within organisations, standardisation of regulatory requirements and improved tracking of outcomes.

SLLS IN PRACTICE

The survey reviewed specific features of SLLs and their use. For example, the survey recorded that 38% of GPs and 55% of LPs preferred sustainability targets that use step-down and step-up margins in direct lending deals. GPs also outlined that where SLLs use step-ups, 41% of GPs allocated incremental interest income to investors. A small number allocated this incremental income to portfolio companies to invest in green projects or capex.

Another finding was a distinction in the suitability of SLLs across industrial sectors – with GPs viewing energy, industrials, utilities and real estate as the most appropriate sectors for SLLs.

Figure 9: Relevance of SLLs by sector



Source: PRI Survey – ESG Incorporation in Direct Lending

During the interviews, market participants shared a range of examples of SLL use in different sectors.

Figure 10: Examples of SLL use in direct lending

Sector	Provider	Example
Utility	**LP, Europe**	A monopoly utility company had a key role in enabling a regional government to meet renewable energy targets. To support this ambition, an SLL was designed to include coupon reductions tied to the achievement of energy diversification targets.
Packaging	**GP, Europe**	As part of a loan to a packaging company for an acquisition, we incentivised the borrower to adopt sustainable packaging practices. This included a 2.5 basis points reduction in the interest rate if the acquiring company implemented a specified plastic reduction target. This was followed up with further interest rate reductions for subsequent targets.
Industrial	**GP, Europe**	High staff turnover was a challenge at this industrial business. This had implications for costs and contract retention. In response the management had implemented a training budget of EUR€75 / quarter for non-job-specific life skills. The SLLs offered them a margin ratchet tied to this social initiative, where they would receive an additional 2.5 basis points margin reduction for implementing and measuring the policy. Further margin reductions were offered for increasing spending on training. This approach helped the company retain employees and stand out as a socially responsible business in the industry.
Industrial	**GP, North America**	SLL-linked provisions were introduced to lending agreements for a network of gas stations. Ratchets were introduced that required the borrower to reduce its operational GHG footprint and install a specified number of EV charging stations. This approach helped mitigate risk, communicate our investment focus and strengthen the relationship with the borrower.
Real estate	**LP, Europe**	This case study was based on a collaboration between the asset manager, borrower and sponsor. The lending structure introduced a target that 75% of onsite properties would achieve an energy performance BREEAM rating in excess of C. The margin would remain at the initial level if the targets were not met but would decrease if the targets were achieved.

PRIVATE LENDER AND PRIVATE EQUITY SPONSOR COLLABORATION

Collaboration among private lenders is the exception rather than the norm: 68% of GPs do not collaborate with other private lenders. In addition, a large majority of private debt lenders believes that private equity sponsors do not want to share ESG data, inhibiting collaboration between lenders and sponsors. This pattern was similar for LPs involved in direct lending, with only a small number collaborating across all deals (5%) and a third collaborating on a case-by-case basis. This would seem to increase duplication of effort while undermining the drive to standardise data collection.

LPs and GPs said barriers for collaboration between market participants include a lack of common frameworks and differing perspectives between private debt and private equity investors on what constitutes relevant data.

Yet a large percentage (89%) of LPs believes there are ways to enhance collaboration among GPs, such as creating standard data reporting formats in deal documentation. Efforts to standardise data collection are underway in similar markets with the launch of the ESG Integrated Data Project in private credit and syndicated loan transactions. It integrates SASB Standards to facilitate disclosure of industry-specific, financially material information by private companies.

The interviews and survey highlighted that aligning data requests and formats decreases time spent on data collection.

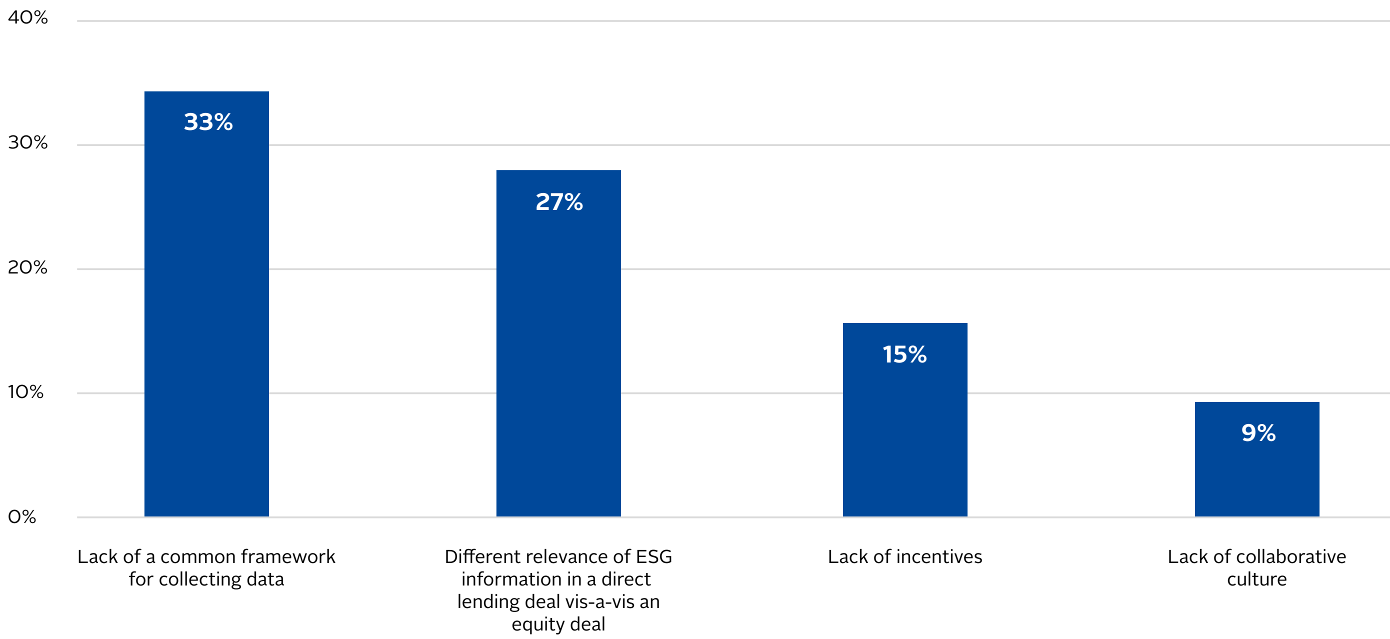
"(Private equity managers) … could share that data with us, but I think they gather the data and feel like it belongs to them, so they either don't think about sharing it or they don't want to share it."

GP, Europe

"Collaboration is key between debt providers and private equity owners because when you invest in capital or debt in the same company, you should basically have the same goal: to make the company transition to a greener and more financially sound state."

GP, Europe

Figure 11: Barriers to sharing ESG data between private equity and private debt investors



Source: PRI Survey – ESG Incorporation in Direct Lending

CLIMATE-RELATED RISKS AND TARGETS

Despite ongoing difficulties in terms of data quality, verification, resourcing and engagement, LPs and GPs have improved management of climate-related risks throughout the investment cycle. There has been a notable increase in adoption of the TCFD reporting requirements, and net-zero commitments have become more prevalent in private debt investment portfolios. Improved data collection has been crucial to enabling these actions. Private debt GPs reported using emissions data more frequently and there is more widespread carbon footprinting.

LPs also have rising expectations of GPs around climate commitments and targets. These LP expectations are clearly laid out in the Net-Zero Asset Owner Alliance's Call to Action to Private Market Asset Managers, which highlights the crucial role private debt plays in allocating capital and funding the net-zero transition. The call-to-action outlines three high-level expectations:

- make public commitments to net-zero targets for Scope 1 and 2 financed emissions;
- offer products that help asset owners meet such commitments;
- create time-bound plans to set decarbonisation targets at a sector level by 2025.

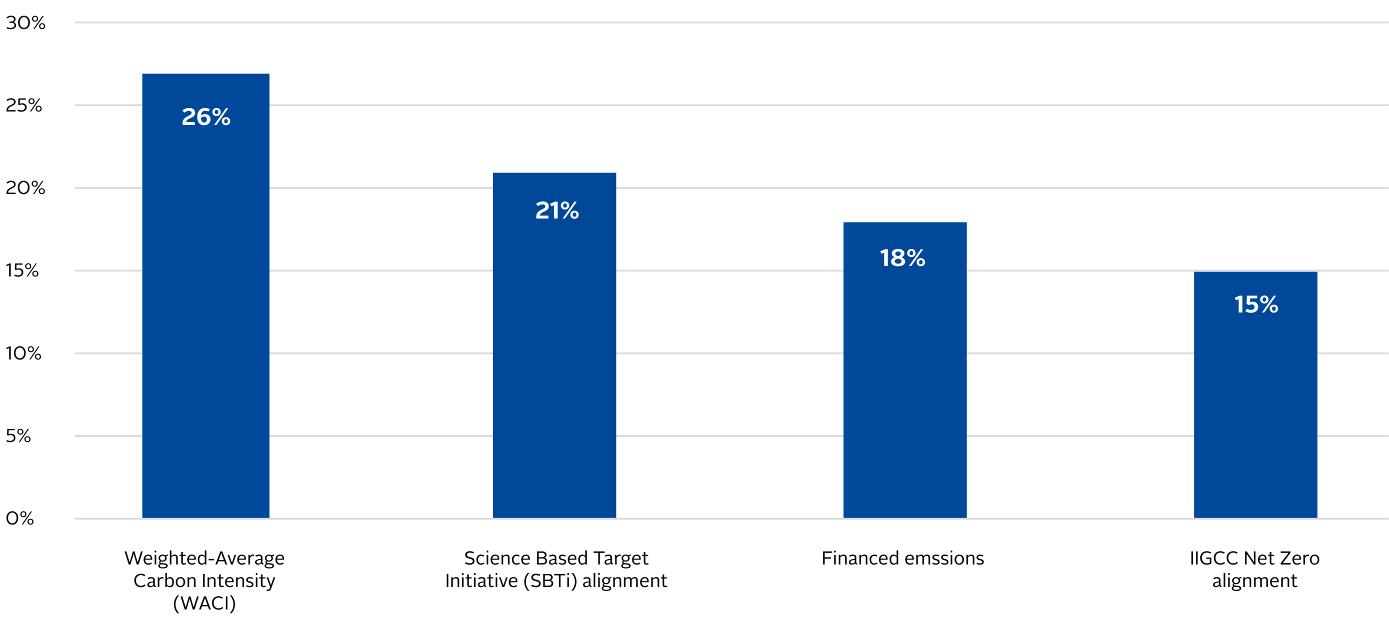
To explore how private debt investors are addressing climate-related risks, the survey drilled down into the four categories below. The survey and interviews also revealed some key challenges, which are summarised.

MEASURING AND MANAGING CLIMATE-RELATED RISKS

According to the survey, two-thirds of LP respondents mandate that private debt GPs measure and manage climate-related risks for both mainstream and sustainability funds. The information sought by LPs includes disclosure on the greenhouse gas (GHG) emissions footprint of borrower entities and progress / activities of borrower entities in reducing GHG emissions. A fifth of LPs mandate that GPs report portfolio-level data, and 43% are planning to do so. Portfolio-level GHG reporting is clearly something that needs to be on the agenda for GPs.

In direct lending, the survey shows 61% of GPs undertake measures to manage climate-related risks in portfolios. Approximately one-third of respondents take steps to estimate or measure GHG emissions of borrowers on a case-by-case or sector basis. A significantly lower percentage undertake more systematic approaches to measuring across portfolios, using multiple sources or forecasting GHG emissions.

Figure 12: How LPs measure funds' exposure to climate-related risks



Source: PRI Survey – ESG Incorporation in Direct Lending

REPORTING

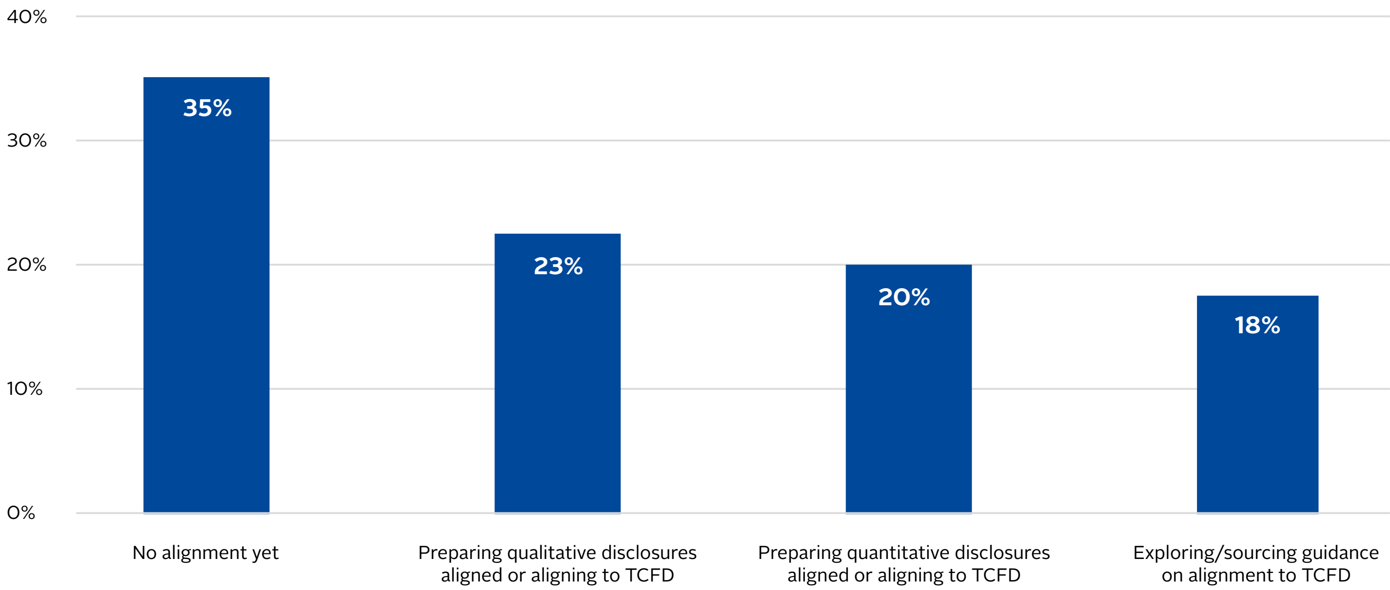
Increasingly the TCFD is being used as a key reporting framework by GPs and LPs in private debt markets.[4] The survey showed that half of LPs are preparing either quantitative or qualitative disclosures aligned with the TCFD reporting requirements. This represents significant progress since our last report in 2019.

Whether GPs use the TCFD framework or not, LPs expect GPs to provide them the GHG footprint of borrower entities and the progress or activities of borrower entities related to emissions reduction targets.

> "Many LPs want to know the sources of largest emissions, the levers to reduce them, and what the GP is doing to address this. Bucketing assets by materiality and intensity is a must-have for planning prioritising investment stewardship actions."
>
> Global insurer, Europe

> "We have developed a platform internally that will allow our underwriters to estimate both the carbon intensity and carbon footprint of our underlying borrowers. The commitment we made under Article 8 was to keep the carbon intensity of our fund lower than the benchmark, which is the leveraged loan index."
>
> GP, North America

Figure 13: GPs' alignment with TCFD



Source: PRI Survey – ESG Incorporation in Direct Lending

4 PRI (Mar 2023), Inside PRI Data: Investment manager practices

TARGET-SETTING

The survey showed that most LPs are making efforts to set targets and metrics for net-zero commitments internally and to mandate that GPs do the same. Only a third of survey respondents do not have a roadmap for net-zero commitments or decarbonisation pathways. Guidance for private market investors to introduce net-zero portfolio targets is still developing[5] and at present there is no established sector guidance for private debt investors. According to the survey, only a fifth of GPs are planning to incorporate detail, such as sector-specific decarbonisation pathways, from organisations such as SBTi, the International Energy Agency and the International Renewable Energy Agency.

"Industry needs to do much more in terms of integrating net-zero and climate targets ... we expect everyone to start integrating decarbonisation targets into their fund strategies from next year onwards... We also want to see a commitment that your firm is driving this."

LP, Europe

"As we're only in the early stages of moving towards net zero, we're simply requesting that the GPs report their processes for achieving net zero, their thoughts on net zero, and how they plan to move towards it."

LP, North America

"When it comes to physical and economic risk, we work with the borrowers and our asset manager partners to understand the Scope 1, 2, and 3 emissions. Are they signatories of any net-zero path? Do they have committed carbon reduction targets verified by SBTi? Additionally, we are doing a more holistic ESG assessment of the borrower itself. "

LP, Europe

5 PRI (2023), Climate change for private markets

SCENARIO ANALYSIS

The PRI's recent analysis of responses to the PRI Reporting Framework highlighted that, despite a strong level of support for TCFD, signatories' use of different climate scenarios to help portfolio construction was limited. The survey reflected this challenge, with 75% of GPs reporting that they are assessing how to build this approach into private debt deals. Interview and survey data highlighted that constructing realistic scenarios is problematic if ESG data is incomplete and proxies or estimates are either unavailable or unreliable.

KEY CHALLENGES

Key challenges relating to private debt and climate commitments fell into the following categories:

Data

- Data coverage on all ESG factors is more limited than in many other asset classes. For example, an interviewee said only 14% of borrower entities were disclosing Scope 1 and 2 emissions.
- Emerging software and data tools are primarily designed for private equity investors, not the direct lending market.

Resourcing

- Direct lending deals are mostly conducted with smaller businesses with limited expertise and resources, making it difficult for them to provide climate data or undertake a climate scenario analysis.

Engagement and holding periods

- The ownership rights, holding periods and governance structures of private equity investors mean they are better placed than direct lenders to encourage investee businesses to improve disclosure and action on climate.

> "I believe it is still early days, and there is currently much debate about whether those models were designed for equity, which they were, and don't always consider debt ... implied temperature rise models are typically intended for equity, which measures the value of your investment rather than whether you will receive repayment."
>
> GP, North America

> "We monitor transition risk from an overall macro-policy perspective. But in this space, it's small and medium-sized companies with very lean teams that have never heard of a carbon footprint. So, we're really starting by setting a fundamental baseline, and then we hope to build from there."
>
> GP, North America

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UN environment programme | finance initiative

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact