Principles for Responsible Investment

STEWARDSHIP IN PRIVATE DEBT

A guide for general and limited partners

JULY 2025

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.

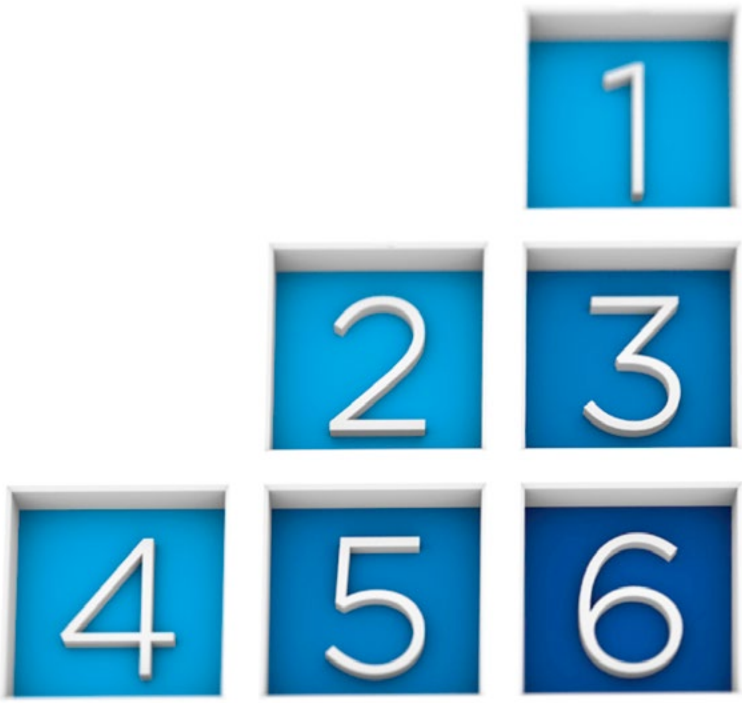
2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

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; fostering good governance, integrity and accountability; and addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

FOREWORD

I am pleased to see that private debt investors have continued to advance their responsible investment practice since the PRI's previous reports on the asset class in 2019 and 2023. The integration of sustainability factors into credit risk assessments is becoming more common, and industry-wide initiatives are making tangible progress in improving access to reliable data and driving convergence around standardised templates.

A particularly promising development is the growing use of sustainability-linked covenants and margin ratchets – tools that not only support risk management and value creation but also contribute to the achievement of sustainability objectives. However, it is important to emphasise that stewardship in private debt is not limited to these tools, and I hope this report supports the ongoing evolution of investor thinking and strengthens stewardship practices within private debt. Our ultimate ambition is for this progress to deliver risk-adjusted returns for investors alongside positive, real world sustainability outcomes – outcomes that continue to be central to the mandates of asset owners and the expectations of regulators.

The investment case for responsible investment must be resilient across varying geopolitical and policy landscapes. Our engagement with over 120 private debt investors during this project has reconfirmed that there remains a strong rationale for responsible investment – namely that incorporating financially material sustainability risks and opportunities aligns with investors' fiduciary duty.

As we navigate today's complex and dynamic environment, it is essential for the responsible investment community to continue to work together, engage in dialogue and share best practice. I would like to sincerely thank our signatories who participated in the survey, interviews and workshops that underpin this guide. Your willingness to share insights is vital to the continued advancement of responsible investment globally. I am also grateful to Redington for its valuable support in delivering this report.

David Atkin,
CEO, PRI

CONTENTS

EXECUTIVE SUMMARY

1. **Stewardship in private debt can enhance risk management and value creation.** While value preservation and the return of capital is the primary motivation for providers of private debt, effective stewardship allows lenders to improve a company's long-term sustainability performance, thereby driving value creation. Features unique to private debt – such as adjusting borrowing costs through margin ratchets – offer lenders meaningful levers for influence.

2. **Spectrums of influence determine the scope of stewardship activities for private debt investors.** These refer to a range of factors affecting the ability of a lender to conduct stewardship. A lender is rarely at the top of every spectrum of influence in each transaction, but equally few lenders are at the bottom of every spectrum. There is nearly always an opportunity to conduct stewardship to some degree.

3. **There are four key stewardship tools available to private debt investors,** based on discussions with investors in this asset class: sharing resources and providing training; ongoing engagements with sponsors/borrowers; sustainability-related covenants and margin ratchets; and advocacy and collaborative engagements. The first two are standard activities observed across most lenders, while the latter two are more advanced, practiced by fewer, or more common in certain jurisdictions. This guidance includes detailed analysis of these approaches and case studies.

4. **The private debt investment lifecycle includes stages where stewardship is especially effective.** Lenders typically have the most influence pre-investment but can continue to engage and apply stewardship tools throughout the holding period. Although deal timelines often prevent finalising stewardship instruments like ratchets before closing, including standardised sustainability clauses in loan documentation, with specific terms finalised post-close, has proven effective.

ACKNOWLEDGEMENTS

The PRI would like to thank the members of its Private Debt Advisory Committee for their insights and feedback, which informed this guide. As of June 2025, members included:

- Allianz Group
- ADM Capital
- APG Asset Management
- Apollo Global Management
- Arcmont Asset Management
- Ares Management
- California State Teachers Retirement System (CalSTRS)
- Hayfin Capital Management
- HPS Investment Partners
- Intermediate Capital Group
- KKR
- Norsad Capital
- Pemberton Asset Management
- M&G
- Oaktree Capital Management
- Oak Hill Advisors
- Pension Protection Fund
- Qualitas
- Public Sector Pension Investment Board
- Tikehau Capital

The guide also draws from insights provided by other market participants who we would like to thank, including:

- Barings
- Carlyle Group
- Edelweiss Asset Management
- H.I.G. Capital
- LGT Capital
- Lombard Odier Investment Managers
- Permira

Additionally, we would like to thank Redington, a consultant appointed by the PRI, for its input and support throughout this project.

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 GUIDE

This paper builds on previous PRI research (ESG incorporation in direct lending) that highlighted the need for industry guidance on how private debt investors can effectively practice stewardship to promote long-term value and sustainable practices among companies they finance.

Its aim is to clarify stewardship in private debt and offer practical tools and strategies for investors to engage borrowers and private equity sponsors. The paper stresses stewardship's role in reducing risk and supporting value creation, thereby improving the borrowers' creditworthiness.

The research is based on over 20 interviews – conducted between July 2024 and January 2025 – with private debt fund managers (general partners or GPs) and their limited partner (or LP) investors to gather insights on stewardship practices. Initial findings were presented at three practitioner workshops in February 2025 – in North America, Europe and Asia – with over 120 participants. Feedback and further insights were collected, along with survey results from participants, which support this guidance.

The PRI selected Redington to lead the research process. Redington is a UK-based investment advisory firm with a strong track record in sustainable investment and stewardship. The PRI's Private Debt Advisory Committee supported the design and structure of this guidance.

THIS GUIDANCE HAS FIVE SECTIONS:

1. **Understanding stewardship in private debt:** Stewardship in private debt is multifaceted, and presents a unique balance of challenges and ability to influence outcomes.

2. **Spectrums of influence in private debt:** The level of influence that an investor can exert depends on various factors, including market context, transaction structure, timing and the nature of the borrower. These are important factors for framing effective stewardship.

3. **Challenges facing private debt investors:** The challenges that private debt investors face, such as timing, access and responsiveness, and data quality, influence the effectiveness of specific stewardship tools.

4. **Stewardship tools:** The guidance outlines four main stewardship tools: sharing resources and providing training; ongoing engagements with sponsors/borrowers; sustainability-related margin ratchets and covenants; and advocacy and collaborative engagement.

5. **Integrating stewardship into the investment lifecycle:** Effective stewardship can be integrated throughout the private debt investment lifecycle, from origination to exit.

It also includes two additional sections, one for GPs on resourcing and another with specific considerations for LPs. Links to related PRI content are provided throughout.

OVERVIEW OF THE PRIVATE DEBT LANDSCAPE

Private debt assets under management (AUM) have grown significantly over the past two decades. Direct lending by GPs comprises roughly half of all private debt strategies by AUM, and LPs are increasingly allocating capital to private debt strategies.

The private debt market has expanded significantly since the 2008 Global Financial Crisis, with direct lending by GPs making up about 50% of private debt assets under management (see Figure 1). The remainder consists of indirect lending through fund commitments to other GPs or secondary market purchases (see Figure 2).

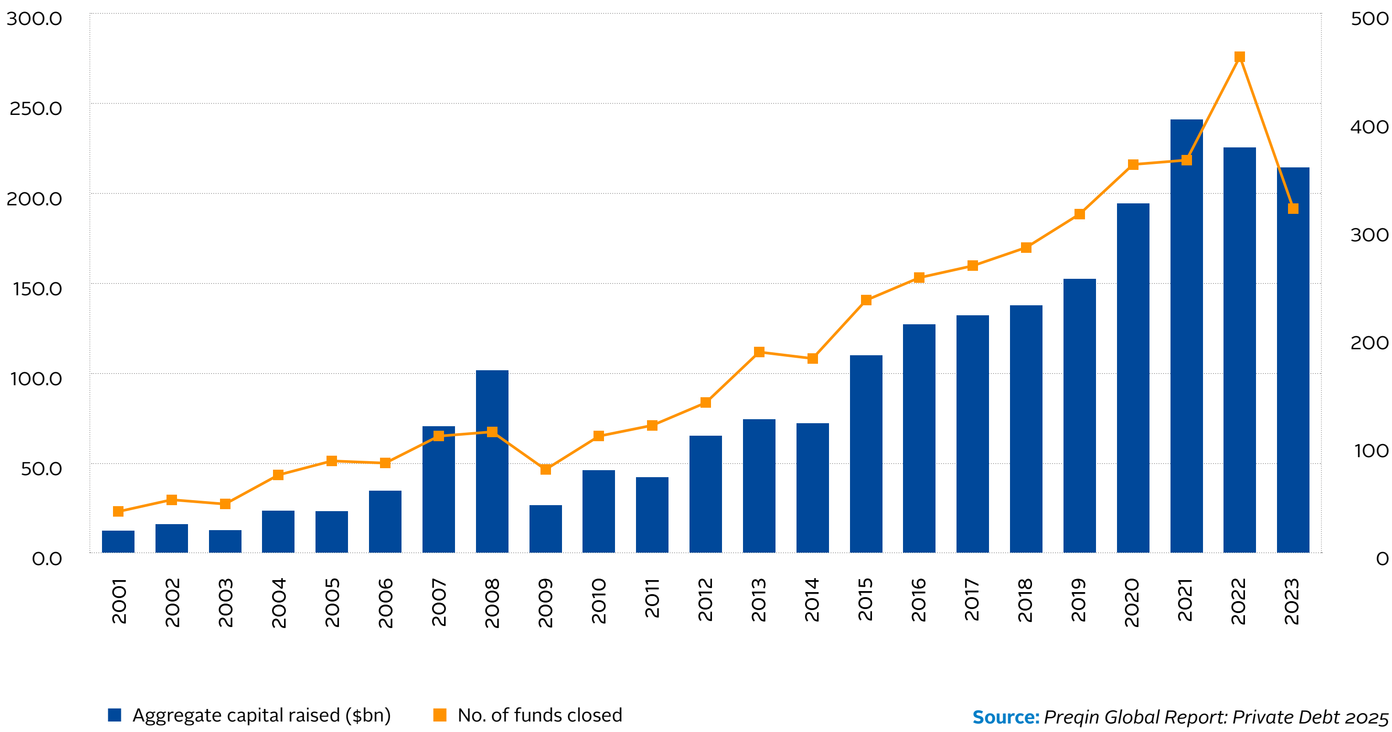
North America leads the market, followed by Europe. Preqin data shows that 80% of global direct lending deals are private equity-backed (or sponsored), where the sponsors assist in structuring transactions. The rest are non-sponsored, meaning borrowers work directly with lenders (see Table 1).

Institutional investors have raised their private debt allocation from 5.7% of AUM in 2023 to 6.4% in 2024 across all investor types (see Figure 4). A recent LP survey also found that most plan to invest more in direct lending in 2025 (see Figure 5).

Table 1: Sponsored vs. non-sponsored private debt transactions

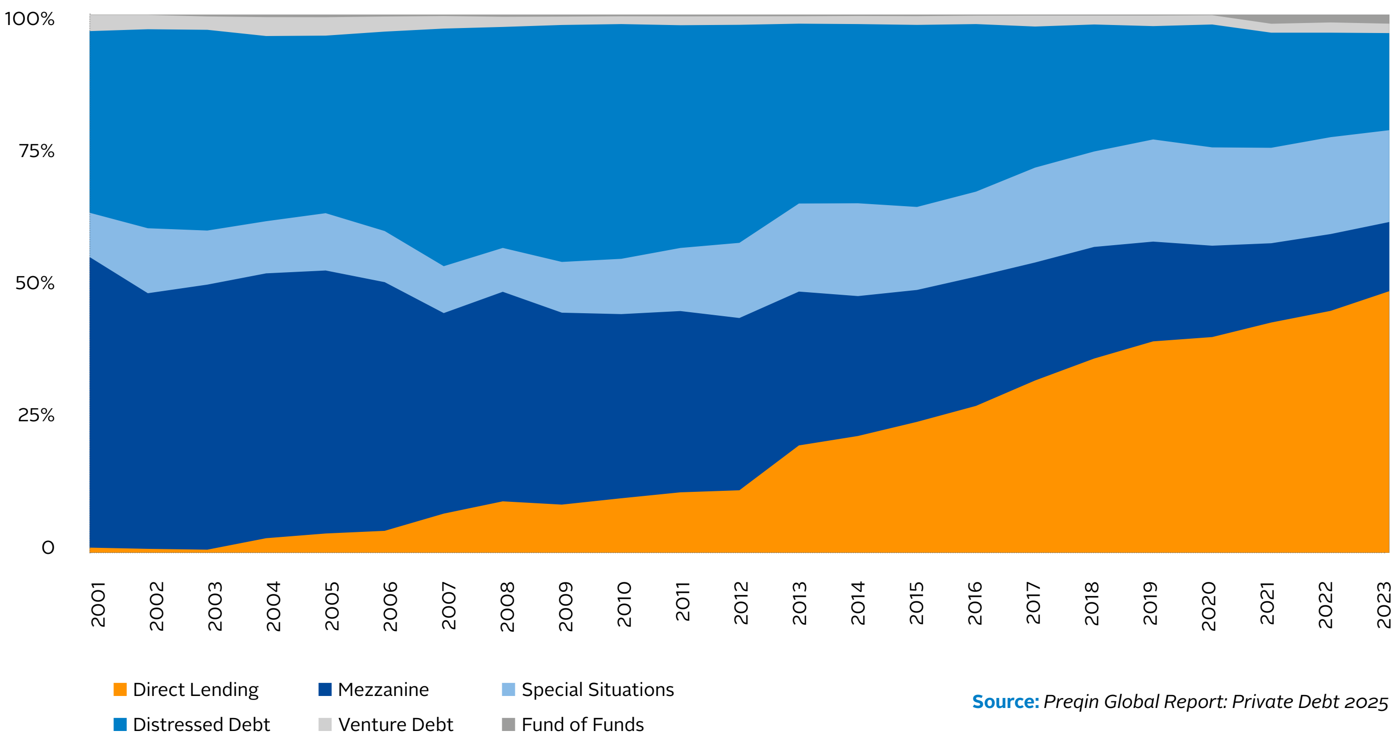
	Sponsored deals	Non-sponsored deals
Sponsor involvement	Backed by private equity firm or other financial sponsor that has invested in the company	No financial sponsor; often founder- or family-owned
Due diligence	Shared with/reliant on sponsor's diligence	Performed entirely by lender
Deal size	Typically larger	Often smaller or mid-market
Risk perception	Lower (due to sponsor support and capital availability)	Higher (no backstop or sponsor support)
Borrower governance	Strong sponsor influence on operations and strategy	Company management retains control
Lender influence	Moderate (sponsor drives major decisions)	Higher (lender has more negotiating leverage)

Figure 1: Global private debt capital raised (2001-2023)



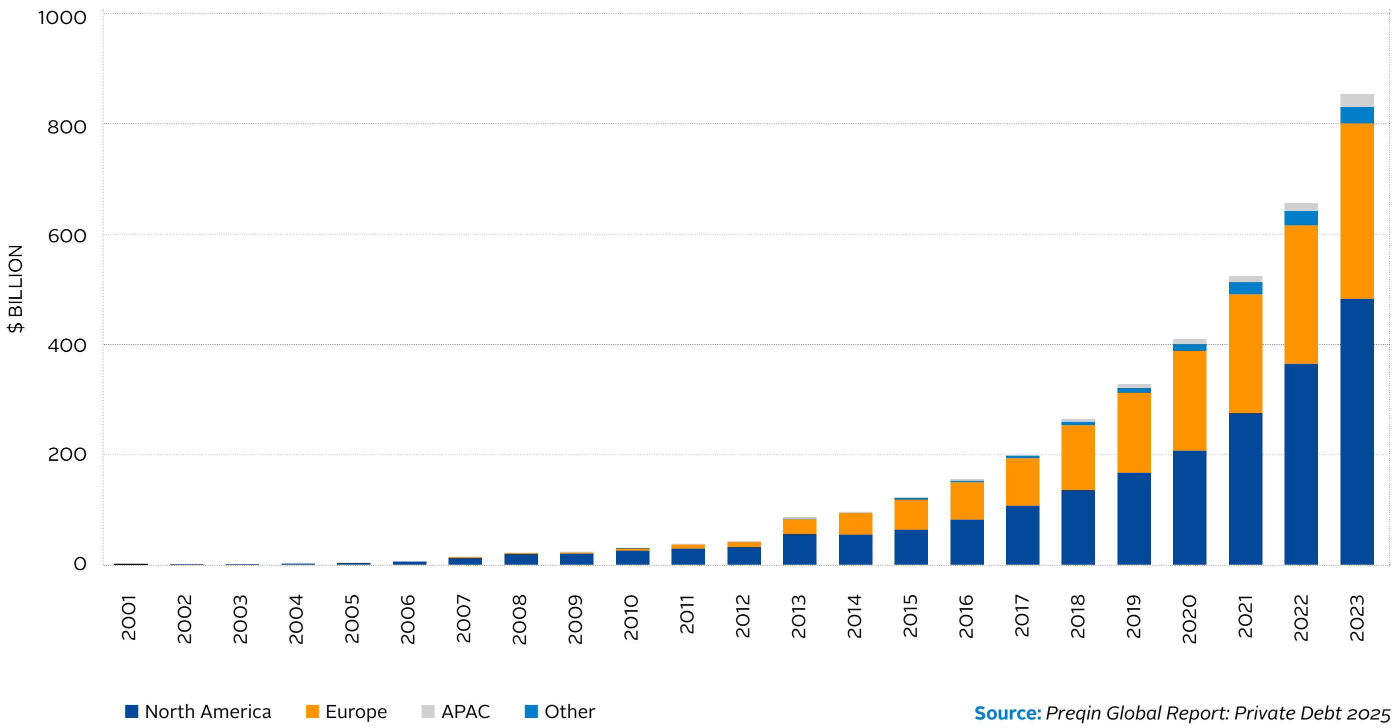
Source: *Preqin Global Report: Private Debt 2025*

Figure 2: Private debt strategies as a percentage of total private debt AUM



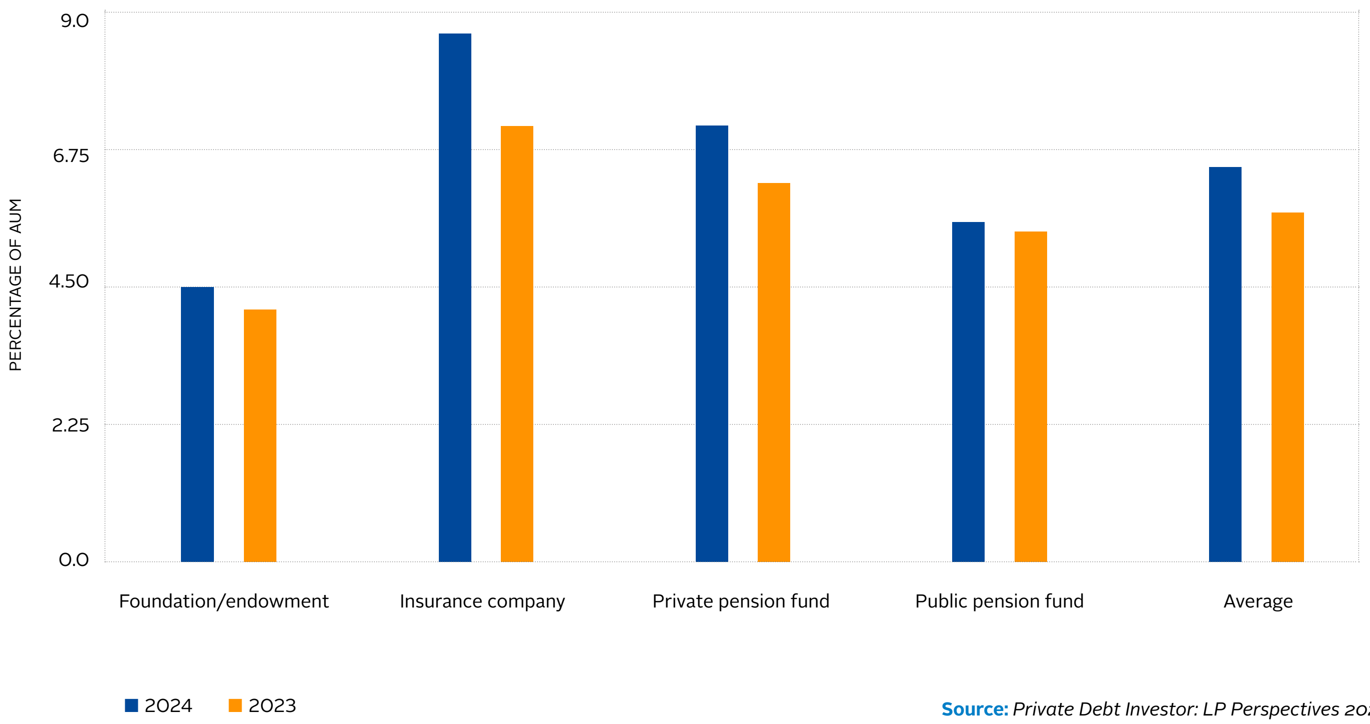
Source: *Preqin Global Report: Private Debt 2025*

Figure 3: Direct lending AUM by region



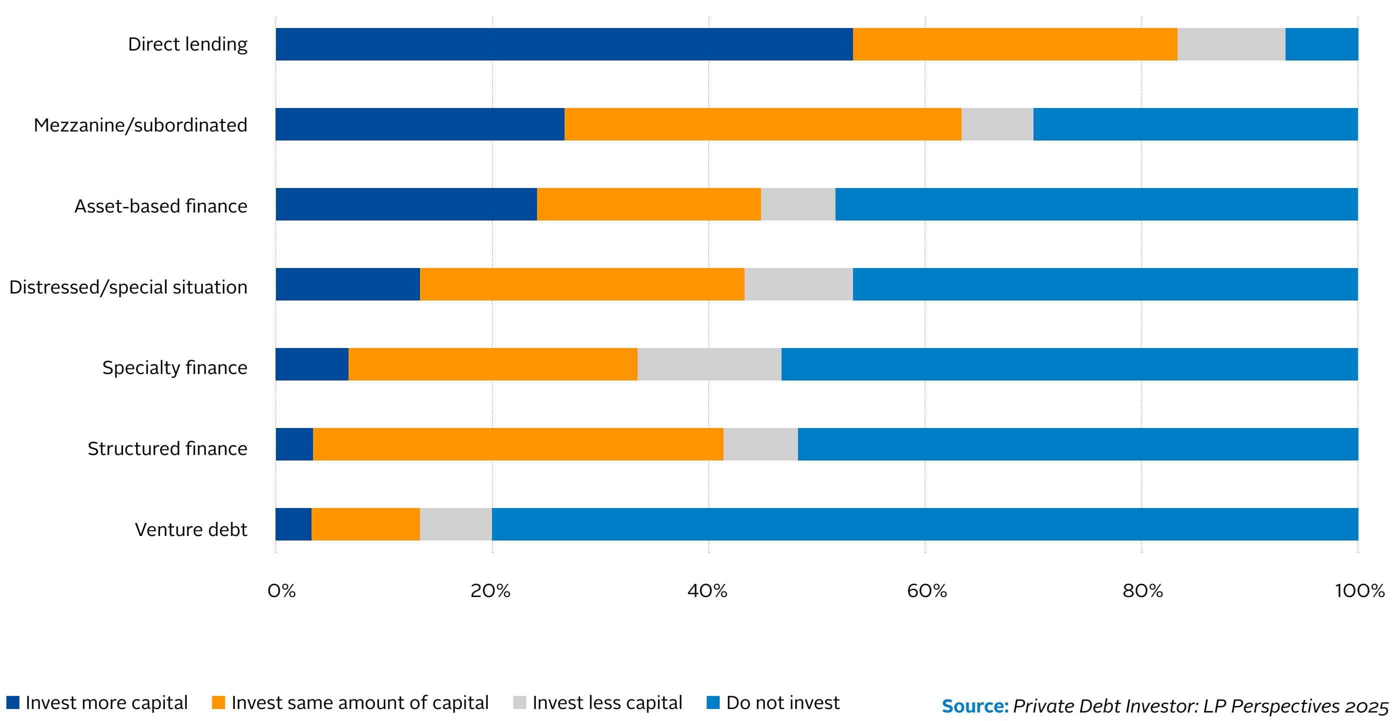
Source: *Preqin Global Report: Private Debt 2025*

Figure 4: Allocation to private debt by institutional investors



Source: *Private Debt Investor: LP Perspectives 2025*

Figure 5: LP private debt strategy appetite in 2025



Source: *Private Debt Investor: LP Perspectives 2025*

UNDERSTANDING STEWARDSHIP IN PRIVATE DEBT

Stewardship in private debt is intended to manage risk and create value, but its practice involves unique challenges, limitations and tools. Given that private debt investors prioritise value preservation and the return of capital, stewardship in this asset class operates differently to that in other asset classes.

The PRI defines stewardship as the use by investors of their influence to maximise long-term value, including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend. This involves active engagement and collaboration to drive long-term value and sustainable corporate practices.

Interviews conducted for this report confirmed that private debt investors apply this definition, with their primary focus on value preservation and the return of capital. However, stewardship in this asset class can also support long-term value creation at investee companies, benefiting shareholders and other stakeholders. Through engagement, lenders can improve the flow of sustainability data and promote practices that preserve or enhance financial value.

Effective stewardship helps lenders reduce risk and improve borrower creditworthiness, thereby helping to preserve the value of the debt. Lenders have unique tools, such as sustainability-related margin ratchets, that can reduce or increase borrowers' loan repayments based on sustainability performance. Such tools are not available to investors in all asset classes.

Investors also noted that their influence as lenders varies across regions, sectors and transaction types, which can present challenges to stewardship.

While this guide defines stewardship broadly, it seeks to focus on direct lending, the largest private debt sub-asset class, so as to provide practical guidance. While we have not explored specifics of stewardship practices in other private debt sub-asset classes, we nevertheless hope that the insights (including the concept of spectrums of influence and the stewardship tools described) will also be useful for other private debt investors in developing stewardship strategies.

SPECTRUMS OF INFLUENCE IN PRIVATE DEBT

The ability of lenders to exercise stewardship operates across independent spectrums of influence, which are shaped by market context, transaction structure, timing and borrower characteristics.

Stewardship in private debt operates within boundaries that shape investors' ability to exert influence. These factors fall into four key areas:

- **Market context** – sustainability disclosure expectations and delivery, and the competitiveness of the lending market.
- **The structure of the transaction** – hierarchy of the capital structure, lender scale, deal sponsorship status (sponsored or not) and the sponsor's own maturity regarding sustainability.
- **Timing** – the investment stage within both the lending and private equity lifecycles.
- **The nature of the borrower** – the capacity and authority of the borrower's representatives, as well as the company's size and sector.

Figure 6 provides a non-exhaustive outline of various factors affecting lenders' ability to utilise the stewardship tools discussed in this paper. It is a guide and does not dictate whether a private debt GP should engage or not.

Each point in each spectrum provides only a rough approximation of influence. Many of these factors are continuous and may include further nuances not captured in a simplified representation.

We refer to these factors as **spectrums of influence** since each operates independently of the others. It is entirely possible that a lender in a particular transaction is at the most influential end of one spectrum whilst also being at the least influential end of another.

That a lender in a private debt transaction is at the least influential end of one or all spectrums does not imply that it cannot carry out any engagement, or that stewardship will never be successful. Participants in the market may still be able to deliver stewardship outcomes even in the most challenging circumstances. This is because, while some of the spectrums operate solely in a single direction, others are less clearly defined. Take company staffing, for example. Many lenders report that borrowers are most able to deliver reporting and other stewardship objectives where they have dedicated resources. However, others note that, where there is no such resource and they can instead gain direct access to top management, it may be possible to deliver more substantive change because of those individuals' scope for decision-making and action.

Figure 6: The spectrums of influence in private debt

		◀ LESS INFLUENCE			MORE INFLUENCE ▶
Market context	Market expectations	Few stewardship levers are typically applied to deals in relevant market			Deals that incorporate key stewardship levers are common in the relevant market
Market context	Regulatory environment	Less enabling			More enabling
Market context	Competitiveness in lending market	Highly competitive market dynamics			Reduced competition in lending market
Structure of transaction	Control position	Small participant in tranche	Significant minority holder		Sole or majority lender
Structure of transaction	Type of deal	Sponsored			Direct (non-sponsored)
Structure of transaction	If sponsored	Sponsor has limited sustainability programme			Sponsor actively considers sustainability matters
Structure of transaction	Position in capital structure	Mezzanine	Junior	Unitranche	Senior
Timing	Financing	Holding period	Initial financing		Refinancing
Timing	Holding period	<2 years	~2-4 years		>4 years
Timing	Maturity of private equity investment	Nearing exit			Early years
Nature of borrower	Company size	Larger	Mid-size		Smaller
Nature of borrower	Company staffing	No dedicated sustainability resource			Dedicated sustainability resource
Nature of borrower	Company sector	Other industries			Energy transition-related industry

CHALLENGES FACING PRIVATE DEBT INVESTORS

Private debt GPs face four key challenges in delivering effective stewardship:

Timing constraints

Access and responsiveness

Data limitations

Challenges with tools

- **Timing constraints:** Limited time for stewardship, especially in competitive markets where deal dynamics compress available time, can restrict a lender's ability to set stewardship goals or negotiate agreements before transactions close. External factors such as sponsors' holding periods further complicate information sharing and stewardship efforts. Lack of standardisation and limited resources further exacerbate these challenges.

- **Access and responsiveness:** Private debt transactions involve multiple parties with varying willingness to engage. Borrower responsiveness is crucial. This is influenced by the maturity of the business, capacity to engage, the significance of the lender in the capital structure and external pressures. Lenders in sponsored deals need access to sponsors and, where possible, should aim for alignment of their stewardship ambitions with the sponsor's approach.

- **Data limitations:** Reliable, high-quality data is often scarce, especially among less mature borrowers and due to the lack of standardised reporting models within private markets. This often leads to detailed negotiations for disclosure requests. Furthermore, there are ongoing debates about the materiality of various sustainability factors across industry sectors, complicating the selection of appropriate metrics. While industry initiatives, such as the Integrated Disclosure Project, provide standardised templates, further harmonisation is required to ensure widespread applicability. Data validation, whether through assurance or simply by management attestation, varies by geography and can be costly. These challenges hinder the measurement of outcomes from engagement efforts.

- **Challenges with tools:** The absence of standardised legal approaches to covenants and margin ratchets can lead to prolonged negotiations. Some market participants question the effectiveness of these ratchets, given challenges in aligning on and evidencing a meaningful reduction or increase in borrower risk related to sustainability factors.

STEWARDSHIP TOOLS FOR PRIVATE DEBT GENERAL PARTNERS

This guide identifies four key stewardship tools for use by private debt investors:

- Sharing resources and providing training
- Ongoing dialogue and engagement
- Sustainability-related covenants and margin ratchets
- Advocacy and collaborative engagement

TOOL 1:

SHARING RESOURCES AND PROVIDING TRAINING

Private debt GPs can provide webinars, workshops and/or conferences to their borrowers to share knowledge and examples of best practice. These might cover material sustainability topics such as decarbonisation, relevant corporate reporting regulations, and sector-specific key performance indicators (KPIs) and sustainability performance targets (SPTs). Co-ordination and collaboration with the sponsor to share resources and provide training is best practice. This ensures the effective use of resources and alignment of messaging and delivery to the borrower.

Common pitfalls include educational materials being too generic and training sessions being ad hoc or infrequent, with no clear action items outlined for borrowers. Lenders report more success with these interventions when they specifically consider the needs and nuances of their borrowers. This may be achieved through the integration and sharing of data collected from sustainability surveys, as well as by encouraging peer-to-peer learning and sharing common opportunities and hurdles.

The GP's investment team, sustainability team or a combination of relevant individuals are typically responsible for information dissemination. The benefits of this include strengthening relationships between lender and borrower and tailoring advice to the borrower's circumstances. In areas where a GP may not have the appropriate in-house expertise (e.g., technical knowledge related to a specific sub-sector) or is seeking impartial guidance, third-party consultants can be used to support a given sustainability programme. Structured programmes on key topics with clear learnings and outcomes for borrowers, run by internal or external experts, can be highly effective in ensuring engagement.

LEADING PRACTICE:

SHARING SUSTAINABILITY DATA AND PROPRIETARY SCORES

Many private debt GPs now collect sustainability data from portfolio companies, often annually, principally to help them assess and monitor risk. They might assess the raw data directly or feed it into proprietary sustainability scoring systems. These scoring systems may also incorporate other factors, such as alignment with the Sustainable Development Goals or monitoring of public controversies.

Either way, GPs are in a unique position to be able to analyse, monitor and benchmark this data (against sector and portfolio benchmarks) and provide feedback to portfolio companies. While borrowers may have access to some of the same data, they may not assess it through the same lens as a lender. Providing feedback to borrowers on key sustainability risks, areas for improvement or progress relative to comparable peers can help preserve and create value for both the GP and the borrower.

CASE STUDY:

2025 DECARBONISATION BOOTCAMP

One global GP interviewed for this report launched a Decarbonisation Bootcamp programme for private credit portfolio companies, building on a previous programme for private equity portfolio companies. It comprises seven training sessions over the course of six months, educating portfolio companies on climate change, emissions calculation, target setting and physical risk analysis. It is designed to take companies through the entire decarbonisation journey, combining a structured approach with customisable content. The aim is to equip companies with the knowledge, tools and resources to decarbonise as part of their value creation and risk management activities.

These types of workshops and bootcamps can be particularly effective because:

- They are interactive and add value for both the GP and portfolio companies. The portfolio companies are provided with useful resources and education, and the GP has the opportunity to learn more about the decarbonisation journey and challenges facing individual companies across different sectors.
- They offer portfolio companies the opportunity to connect with and learn from each other. Breakout sessions, for example, can be grouped into asset-light and asset-heavy businesses, so those with low Scope 1 and 2 emissions can focus discussions on how to reduce Scope 3 emissions, and vice versa.

TOOL 2:

ONGOING DIALOGUE AND ENGAGEMENT

Ongoing dialogue and engagement with portfolio companies is central to stewardship in private debt, and lenders have many opportunities to engage with sponsors and borrowers, as discussed in the Integrating stewardship into the investment lifescycle section. Through regular engagement, lenders can be confident in their knowledge of the borrower's financial position as well as any sustainability risks and opportunities. Lenders often aim to highlight these risks and opportunities by using Tool 1 – sharing data and providing educational and advisory services – thereby mitigating sustainability-related risks and increasing the likelihood that the debt will be repaid in full.

An initial meeting during due diligence to set expectations and understand the borrower's business and sustainability practices can be an effective way to align priorities at the start of the deal lifecycle. Lenders can reach out to the sponsor to establish key points of contact, understand its sustainability approach and hear its assessment of sustainability risks and opportunities at the portfolio company. It is important for lenders and sponsors to align their thinking on these key areas to have impactful engagement.

Many lenders use a sustainability due diligence questionnaire as a touchpoint for engagement. It should be made clear to the sponsor and/or borrower what the purpose of the questionnaire is and how it should be completed. In deals with multiple lenders, the lenders can co-ordinate on an appropriate questionnaire – this may be led by a sustainability co-ordinator (often the lead lender). The sustainability co-ordinator is generally appointed by the borrower to help align the sustainability objectives of the lenders and manage data collection and monitoring. The Loan Market Association's Best Practice Guide to Sustainability-Linked Leveraged Loans provides more detail on this role.

CASE STUDY:

USING A SUSTAINABILITY RATCHET DURING A SPONSOR-BACKED TRANSACTION

One European GP proactively engaged with a sponsor by implementing an ambitious sustainability ratchet, closely aligned with the sponsor's energy transition fund.

This engagement began promptly during the due diligence phase and involved both the sponsor and the borrower. The GP conducted a detailed assessment of the borrower's strategy, sustainability priorities and key externalities, identifying meaningful opportunities for engagement. Using its sustainability scoring framework and findings from due diligence, it pinpointed the most material issues, provided relevant benchmarking data and shared expert insights to convince the borrower to implement the sustainability-linked loan to help it strengthen its sustainability approach.

Importantly, two out of the three KPIs selected for the ratchet were carbon-related and fully aligned with the decarbonisation goals of the sponsor's energy transition fund. This alignment not only ensured consistency between the sponsor's and lender's objectives but also accelerated the transition of the company.

RESOURCE:

INTEGRATED DISCLOSURE PROJECT

The Integrated Disclosure Project (IDP) template was launched in November 2022 by leading alternative asset managers and industry bodies. The template aims to enhance transparency, comparability and accountability of sustainability data reporting. It is based on the International Sustainability Standards Board's SASB Standards and provides a clear framework for borrowers to anticipate sustainability data requirements and engage effectively with lenders. The availability of the template has helped increase the volume and quality of data reported to lenders. It has also proved an invaluable resource to support borrowers that lack significant reporting infrastructure.

The IDP template offers several advantages:

- It helps asset owners identify industry-specific sustainability risks and compare data across alternative asset managers.
- It provides borrowers with certainty about relevant sustainability indicators, allowing them to focus on material disclosures.
- It supports engagement by lenders with borrowers and efficient investor reporting processes.

The template establishes a global baseline of sustainability information that covers both qualitative and quantitative data on those sustainability factors that are most material to lenders. Use cases for the IDP include:

- Due diligence
- Borrower engagement
- Portfolio monitoring
- LP reporting processes

The IDP was designed to be accessible to borrowers. A chief objective of this work has been to ensure that the data requested can realistically be provided by businesses of different sizes, including small and medium-sized enterprises. This harmonised approach is already supporting consistent sustainability data disclosure, tackling one of the greatest challenges to sustainability integration in the private and broadly syndicated credit markets.

LEADING PRACTICE:

DUE DILIGENCE QUESTIONNAIRES

Until recently, there was an "as much as possible" approach to data collection for due diligence, which risked overwhelming companies with extensive questionnaires and unrealistic or irrelevant data requests. This issue is not unique to private debt. However, the industry is now coalescing around a due diligence standard anchored in the key points below. The data collected should be:

- **Proportionate and material:** Questionnaires should be proportionate to the size and complexity of the company being assessed and focus on sustainability factors that are material to the company's financial performance and risk profile.
- **Clear:** Questions should be clear and straightforward, with relevant explanations where there is any room for subjectivity, to ensure accurate and consistent responses.
- **Aligned:** Questionnaires should be aligned with broader sustainability initiatives and frameworks, such as the Integrated Disclosure Project, the ESG Data Convergence Initiative and the Private Placements Investors Association.
- **Standardised:** Questionnaires should be based on a standardised template to aid comparison across different companies and sectors.
- **Verified:** Questionnaires should include questions that help verify the accuracy and reliability of the information provided.

An effective approach employed by some managers is for the due diligence questionnaire (DDQ) template to include a short selection of core sustainability questions that can be asked of all companies across all industries, with room to input sector- or company-specific questions from a pre-prepared question bank. These are often based on the SASB standards.

It is important for GPs to be flexible and open to adapting their approach to due diligence as sustainability standards and regulations evolve.

During the post-investment phase, regular calls or meetings are common to discuss performance, address any issues and provide updates on sustainability initiatives. This level of engagement helps maintain strong relationships, ensure ongoing compliance with sustainability targets and identify any emerging material issues that merit attention. As the lender often has greater influence post-investment (regarding certain spectrums of influence), site visits can be an important tool for monitoring compliance with sustainability standards and action plans. These visits help lenders verify the implementation of agreed-upon practices and gather first-hand information about the borrower's operations.

Surveys and data collection carried out regularly (ideally annually) help lenders monitor progress and identify areas for improvement. Surveys that are targeted and aligned with industry standards are most effective. They can provide a useful prompt to re-engage with the lender and re-assess sustainability-related risks and opportunities.

Finally, it is important for lenders to monitor and track engagements with the borrower and sponsor. This will help to ensure that portfolio companies are not overlooked, and are being regularly engaged, as well as helping to determine which engagements are having more success than others.

SPONSORED DEAL:

WHOM TO ENGAGE WITH

Engagement between lenders and sponsors on sustainability issues can be undertaken with the sponsor deal team or with its sustainability specialists. If engagement is with the latter, it is important for the lender to understand how integrated the sustainability and investment functions are at the sponsor. In some cases, the sustainability individual or team at the sponsor operates at arm's length from the deal team and may not be best placed to share information on portfolio companies. In such cases, the deal team at the lender, with support from the sustainability team, is likely to aim to engage with the sponsor deal team on sustainability objectives.

A sponsor with an advanced approach to sustainability and where stewardship is at the core of its investment approach may provide a good learning opportunity for the lender. It can be impactful to align approaches and bring the weight of combined capital to engage with the borrower.

CASE STUDY:

ENGAGING WITH MULTIPLE LENDERS

In engaging on sustainability with one of its portfolio companies, a European GP began by identifying the borrower's most material sustainability risks and opportunities aligned with the borrower's strategic objectives and operating context. The GP then worked with the borrower to define the most relevant KPIs to include in a sustainability ratchet.

The GP presented its proposal to the borrower and the sustainability co-ordinator, which represented the banking syndicate involved in the deal, reaching a preliminary agreement. This was followed by a formal presentation of the ratchet to the broader group of lenders, again in coordination with the sustainability co-ordinator. The proposed KPIs and decarbonisation strategy were accepted, underpinned by robust external benchmarks and a well-substantiated rationale for each metric.

Crucially, the GP was able to convince the borrower to adopt a meaningful decarbonisation trajectory by demonstrating that it was lagging behind its peers in terms of maturity. This not only enhanced the credibility of the borrower's sustainability strategy in the eyes of its lenders but also positioned it more favourably with clients going forward.

CASE STUDY:

ENGAGEMENT VIA QUESTIONNAIRES DURING A SPONSOR-BACKED TRANSACTION

Given the difficulty of engaging with sponsors pre-investment due to time constraints, a European GP conducts an annual post-investment due diligence exercise by issuing a questionnaire to the private equity sponsors with whom it has partnered on direct lending transactions in its portfolio. As a lender with relatively limited direct influence over the sustainability agendas of its borrowers, the GP places significant emphasis on partnering with sponsors who demonstrate a strong commitment to responsible investment.

Upon receiving the completed questionnaires, the GP analyses and scores the responses, creating a universe of sponsor sustainability scores. This provides valuable insight into each sponsor's approach to sustainability – covering commitment, integration and stewardship both pre- and post-investment, as well as transparency.

These insights serve as the foundation for meaningful engagement, enabling the GP to share tailored feedback on best practice, particularly to sponsors at an earlier stage of building their responsible investment capabilities.

This process can also enhance the quality of data received across borrowers in the portfolio and support more robust management of downside sustainability risks. For example, when one sponsor reported measuring emissions across all portfolio companies and setting science-based targets, the GP initiated a dialogue about data sharing. As a result, the sponsor agreed to complete an additional questionnaire concerning several borrowers, facilitating more efficient information exchange, greater transparency and a reduced reporting burden for the underlying borrowers.

CASE STUDY:

USE OF KPIs IN A SPONSOR-BACKED TRANSACTION

A European GP offers a sustainability margin ratchet across its direct lending portfolio, linking loan pricing to carbon reduction targets and sector-specific KPIs. These metrics are shaped through close three-way collaboration between the GP, the sponsor and the borrower.

Targets are set to be stretching yet achievable – aligned with the borrower's sustainability strategy while providing downside protection through improved performance. This engagement also gives the GP a comprehensive understanding of the borrower's sustainability programme at the point of lending and establishes alignment with the sponsor on key areas for progress.

Recent KPIs agreed for an industrial company included:

- ISO 14001 certification: An increase in the number of plants certified for waste management, ensuring compliance with international standards for hazardous and non-hazardous waste handling.
- ISO 45001 certification: Growth in the number of sites certified for occupational health and safety, strengthening oversight of workplace risk management.

These KPIs are embedded in the loan documentation. For companies with advanced sustainability practices, terms are agreed pre-investment; where further development is needed, targets are finalised within six months of the transaction closing. This structured, sponsor-aligned approach ensures that material sustainability factors are advanced through the investment lifecycle.

NON-SPONSORED DEAL:

WHOM TO ENGAGE WITH

When no sponsor is involved, the level of sustainability sophistication at the borrower will dictate which individuals the lender engages with. It can be impactful to meet (at least initially) with C-Suite executives, or the family at family-owned businesses, before continuing conversations with the finance, investor relations or operations teams. Some companies may have a sustainability officer, who can be a useful touchpoint for the lender.

Speaking with management teams can also be extremely impactful, as they will set the strategy for the company. Ensuring their buy-in to stewardship efforts will be highly influential in determining the success of engagement.

While there is no right answer on whom specifically to engage with at the borrower, it is likely to be most effective to speak to a broad set of people to ensure a fuller understanding of the business. Lenders should be flexible, depending on the type and size of company and its management structure.

TOOL 3:

SUSTAINABILITY-RELATED COVENANTS AND MARGIN RATCHETS

While tools 1 and 2 promote organic knowledge-building and positive change, sustainability-related covenants and margin ratchets offer more direct levers for action. These tools mandate and/or financially incentivise the borrower to sustainability action, provide opportunities to improve standards, create value for borrowers, preserve value for lenders and drive an awareness of and commitment to long-term sustainable growth for all stakeholders.

DEFINITIONS:

SUSTAINABILITY-RELATED COVENANTS VS. MARGIN RATCHETS

- **Covenant:** GPs may include sustainability information disclosure or action/progress covenants within loan documentation, similar to financial or reporting covenants. Breach of sustainability-related covenants without sufficient explanation may result in a default.

- **Ratchet:** This is a mechanism that reduces the margin (i.e., the interest paid) if defined sustainability-related KPIs or SPTs are achieved, and/or increases the margin if they are not achieved. GPs may negotiate and structure margin ratchets that are either one-way or which apply in both directions (a two-way ratchet). Based on our interaction with GPs, we found they typically change the interest paid by between approximately 5 and 50 basis points (bps).

COVENANTS

Including sustainability-related covenants in loan documentation can be an effective way to start conversations with borrowers on sustainability objectives and ensure availability of data necessary to assess sustainability risk and opportunity. This is especially pertinent for younger companies that lack the historical performance needed to set credible benchmarks and propose appropriate SPTs.

The most common covenant included in loan documentation by lenders is an obligation to complete an annual sustainability survey on a best-efforts basis or report on selected sustainability-related KPIs. These can be considered as affirmative covenants, whereas negative covenants may also be included to limit exposure to certain economic activities.

Current leading practice is to write into the loan documentation that failure to comply with these covenants may lead to an event of default. This keeps the borrower accountable and provides a strong reference point from which the lender can engage with the borrower. In more competitive markets, these covenants may be implemented on a 'best efforts' basis.

Example: Sustainability-related clauses

Standard practice	Leading practice
▪ Periodic reporting to the investor on selected sustainability metrics. ▪ Compliance with a sustainability due diligence questionnaire and annual sustainability survey. ▪ Written notice provided to the lender upon knowledge of any material change in, occurrence of an event reportable under, or deviation from the sustainability position established in the sustainability DDQ.	▪ Third-party verification of the borrower's sustainability performance. ▪ Margin adjustments based on the borrower's performance against SPTs. ▪ Clauses that specify how loan proceeds should be used to support sustainability initiatives. ▪ Provisions where failure to meet certain sustainability criteria could trigger an event of default.

Negative covenants can also be included in documentation, restricting the borrower from undertaking certain economic activities.

CASE STUDY:

SUSTAINABILITY CREDIT FACILITY COVENANTS

One European GP that was interviewed includes an ESG Principles section in every note purchase agreement, ensuring that borrowers acknowledge the importance of sustainability and make commercially reasonable efforts to:

- comply with any policy or framework described in the GP's sustainable investment policies;
- adhere to any sustainability representations made at the time of investment.

The GP also mandates that borrowers provide written notice of any material deviation from the sustainability representations they make at the time of the investment, including those in the sustainability DDQ. They are also required to provide information to assist the GP in updating its sustainability assessments and stewardship strategies (no less than annually), and provide periodic reporting to the GP on selected sustainability metrics. These may include, but are not limited to, Principal Adverse Indicators set out in the EU's Sustainable Finance Disclosure Regulation (SFDR).

Private debt GPs can go beyond disclosure-based covenants, writing sustainability action plans into loan documentation and mandating board seats, either as a voting or an observer seat. Board-level oversight and influence over the company's operations enables enhanced engagement with the borrower. However, board seats tend to only be available to those operating furthest along of the spectrums of influence, in non-sponsored transactions and in a conducive legal and regulatory environment. In addition, in situations where the borrower is in financial distress or undergoing restructuring, lenders may be able to take board seats to protect their investment and steer the company towards recovery. While these special situations can present an opportunity for lenders to demonstrate how a sustainability objective aligns with material outcomes, both borrowers and lenders will deprioritise all but the most obviously financially material factors when in financial distress.

CASE STUDY:

ENVIRONMENTAL AND SOCIAL ACTION PLANS

One GP operating in the Asia-Pacific region successfully engaged with a luxury furniture and design company, contributing to sustainability improvements at the company. This GP engages in direct lending to small corporates (generally with earnings of US$20m-US$40m) in non-sponsored transactions, therefore operating further along the spectrums of influence. The manager has a history of building strong partnerships with borrowers and delivering environmental and social objectives.

As part of its engagement, a third-party sustainability due diligence process was undertaken, including site visits to two different manufacturing sites, each of which presented its own sustainability challenges. A time-bound environmental and social action plan was developed to mitigate and manage the sustainability risks identified, and this was embedded in the loan covenants as a potential event of default in the event of non-compliance. The GP also took a board seat as part of the action plan.

At the time of the investment, the company lacked an overall sustainability policy and strategy, despite the obvious sustainability risks posed by its manufacturing operations. There was no consistent approach to sustainability risk management as well as a lack of knowledge within the group. However, there was strong support and commitment from the company's senior management to address sustainability risk: this was key to implementing and advancing the company's sustainability practices and performance in collaboration with the management team.

After the initial sustainability due diligence process, a two-pronged approach was adopted to reassess and rebuild the company's sustainability strategy. It set up a dedicated sustainability team with a direct reporting line to senior management and hired a third-party consultant to help draft and implement an environmental and social management system in line with the requirements of the International Finance Corporation's Performance Standards. The company also embarked upon specific sustainability projects, such as measuring baseline greenhouse gas (GHG) emissions, setting up a supply chain management system and exploring alternative raw materials.

The company achieved the sustainability target established and was awarded a gold rating from the Leather Working Group, a not-for-profit sustainability initiative. It also significantly reduced its use of energy, water and chemicals. Its sustainability team received ongoing support and strategic advisory services, focusing on reducing carbon emissions. The company has been able to assess and report its Scope 1 and 2 carbon emissions and is working on understanding its Scope 3 emissions.

The company has made significant progress since the initial funding, exemplifying how direct engagement can enable progress in managing sustainability risks effectively and help build stronger companies.

MARGIN RATCHETS:

SUSTAINABILITY-LINKED LOAN VS. SUSTAINABILITY-RELATED MARGIN RATCHET

Sustainability-linked loans (SLLs) are standalone loan facilities structured with comprehensive sustainability performance targets (SPTs) linked to clearly defined key performance indicators (KPIs) embedded directly in the loan agreement. These targets are typically borrower-specific, quantitative, ambitious and externally validated. Pricing adjusts periodically (e.g., annually) based on whether these targets are met or missed, with step-ups or step-downs in the loan margin. SLLs are often supported by detailed reporting, third-party verification and clear sustainability frameworks, serving as a formal mechanism for aligning borrower incentives with sustainability goals.

Sustainability-related margin ratchets are typically embedded within conventional loans, adjusting the loan margin by a pre-negotiated number of basis points based on the achievement of one or more SPTs (typically less in number than for an SLL and ranging from quantifiable targets such as emissions reductions to softer targets such as reporting commitments or policy adoption). These targets and associated KPIs may not rise to the rigour, scope or verification standards of a full SLL structure but still incentivise borrower progress.

While SLLs are particularly well suited to larger/more mature borrowers in industries with greater scope for ambitious sustainability targets e.g., high-emitting sectors, this guidance focuses primarily on sustainability-related margin ratchets which are a more widely applicable and straightforward tool lenders can implement, both as part of SLLs and as part of their usual financing activities for a wide range of borrowers.

Lenders have seen mixed success with sustainability-related margin ratchets, but some positive outcomes have emerged over the past few years. While ratchets can be unique and impactful stewardship tools for private debt GPs, it is important to note they are not suitable in all cases. Their market uptake has been slow, although the industry is now coalescing around seven key factors that determine the success of these ratchets:

Selection: Sustainability-related margin ratchets are not always appropriate. Proposing margin ratchets in inappropriate situations may negatively impact relationships with sponsors and borrowers. A ratchet is only suitable if the KPI/SPT addresses a material risk or opportunity for that company. Using resources like the SASB framework to establish material sustainability KPIs and SPTs is recommended. Some GPs create their own materiality framework templates, using resources from institutions such as SASB and the Global Impact Investing Network.

Table 2 provides examples of sustainability KPIs and SPTs reported by GPs interviewed for this report. This is not intended to be an exhaustive list but to provide an indication of some of the metrics that GPs consider material for investee companies.

Table 2: Common KPIs and SPTs

	KPIs	SPTs
Environmental	GHG emissions	Annual targets for reducing GHG emissions, measured by an absolute or intensity metric, often in line with the Science Based Targets initiative (SBTi).
	Water consumption	Annual % reduction in water consumption/ withdrawal.
	% of renewable energy use	Annual target to increase proportion of energy sourced from renewable sources.
Social	Occupational injuries	Annual % reduction in the number of workplace injuries or reported incidents.
	Employee engagement	Annual % improvement in employee survey scores; annual % increase in spend on training or social initiatives; annual % reduction in employee turnover.
	Unadjusted gender pay gap	Annual % reduction in the unadjusted gender pay gap.

Collaboration: Effective implementation of ratchets should be supported through a strong relationship between lender and borrower, a shared understanding of how sustainability considerations may add value or mitigate risk to a given company, and willingness of all parties to negotiate and collaborate. The SPTs on which ratchets are based should be ambitious but achievable and any covenants should also consider timescales to allow borrowers to appropriately resource or invest in reporting infrastructure to be able to provide the necessary information to GPs.

Timing: Conversations around ratchets may take place pre-deal, although they are rarely finalised by deal close, given the usually tight timescales. Finalisation of terms in loan documentation alongside financial KPIs during the investment approval stage is most effective. However, given time and resource constraints, many GPs negotiate final terms within six months of a deal closing. If negotiations run on beyond six months, momentum can be lost and engagement with the borrower can become challenging. The incentive to use such a tool also declines as the time to maturity of the loan decreases. Formalising an engagement timeline pre-investment can be an effective approach to mitigate this risk.

Margin ratchet structure: Ratchets can be structured as step-up, step-down or two-way. A two-way ratchet that is both rewarding and penalising in equal measure is the most effective tool to hold borrowers to account on sustainability. However, in more competitive markets where this approach may not be possible, a step-down ratchet can be an effective way to start the conversation around sustainability risks and opportunities, and reward a lender for addressing a sustainability risk. It should be noted that a ratchet should incentivise borrowers to achieve and then maintain a certain standard. So, while the achievement of a target initially can reduce the margin, a ratchet can evolve to become two-way, whereby the margin can be increased again if the borrower lets sustainability standards slip.

Margin adjustment: It is challenging to assign a financial value to the risk mitigated or the value added at a company by meeting a sustainability-related KPI. No GPs that we spoke to currently employ a quantitative risk or valuation-based approach to setting the basis point adjustment of the sustainability-related margin ratchet. Lenders typically use a wide range of basis point adjustments, from approximately five to 50 bps, with the most common approach being an adjustment of 2.5-7.5 bps per KPI, and to select two or three KPIs. The focus should be on the quality and materiality of KPIs and associated margin adjustments, rather than quantity: one relevant and material KPI is preferable to several non-core KPIs. When implementing a ratchet, it is important that the cost of achieving the target and verifying the data does not exceed the saving to the borrower from the reduced margin payments.

Verification: To enhance credibility and effectiveness of sustainability-related margin ratchets, involving consultants or third-party verification is advisable. These external parties can provide assurance, reduce the risk of greenwashing and ensure that the reported sustainability improvements are genuine.

Frameworks: Using established loan principles, such as those from the Loan Syndication and Trading Association (LSTA), can provide a solid framework for implementing sustainability-related margin ratchets.

CASE STUDY:

SUSTAINABILITY-RELATED MARGIN RATCHET

One European GP, having identified an opportunity to reduce risk at a borrower by improving its carbon emissions profile and regulatory readiness, arranged a sustainability-linked loan for the company, setting two KPIs and related SPTs linked to decarbonisation. They were:

- KPI #1 – Scope 1 and 2 absolute GHG emissions
- KPI #2 – Scope 3 absolute GHG emissions
- SPT #1 – Annual 5.5% reduction in Scope 1 and 2 GHG emissions
- SPT #2 – Annual 5% reduction in Scope 3 GHG emissions

The targets were set by an independent third party in line with the SBTi methodology and an action plan was presented to the pool of lenders by the sustainability coordinator and the company's management, highlighting how the company could achieve these targets. This SLL was negotiated before the closing of the transaction, which was made possible by early discussions between the company, its sponsor and the sustainability co-ordinator.

A two-way 7 bp adjustment was attached to SPT #1 and a two-way 11 bp adjustment to SPT #2, making a potential 18 bp annual adjustment to the cost of the loan. The calculation and reporting are subject to annual review by a reputable third party.

RESOURCE:

ESTABLISHED SUSTAINABILITY-LINKED RATCHET GUIDANCE AND PRINCIPLES

Using established loan principles can provide a solid framework for implementing sustainability-related margin ratchets. For example, the LSTA's Sustainability-Linked Loan Principles and France Invest's Best Practice Guide for Private Debt: Sustainability-Linked Financing align on the following key factors for successful implementation of a sustainability-related margin ratchet:

- Relevant, material and quantifiable KPIs should be selected that align with the borrower's sustainability strategy and business model.
- SPTs should be clearly defined, benchmarked against industry standards (e.g., from the International Capital Market Association or the European Leveraged Finance Association) to ensure they are challenging yet achievable, and they should be regularly monitored.
- The economic terms of the loan, including the interest rate adjustments, should be directly linked to the borrower's performance against the SPTs. This creates a financial incentive for borrowers to improve their sustainability performance.
- Regular and transparent reporting on the borrower's progress towards the SPTs is crucial. This includes disclosing the methodologies used for measuring performance.
- Independent external verification of the borrower's performance against the SPTs is recommended to ensure credibility and to avoid greenwashing. This can be done by an accounting firm, consultant or a rating agency.

TOOL 4:

ADVOCACY AND COLLABORATIVE ENGAGEMENT

RESOURCE:

STEWARDSHIP IN PRIVATE EQUITY

As discussed in the PRI's Stewardship in private equity guide published in March 2024, private markets investors can conduct stewardship at the company level and at a more systemic, capital markets level. Private debt investors can leverage the framework outlined in that guide, focusing on the levers of:

- Public policy engagement
- Contributing to public goods
- Influencing standards through collaboration

Private debt GPs should review this previous guidance, as the principles discussed apply equally to private debt as to private equity.

Engagement at the systemic, capital markets level is crucial in markets with underdeveloped standards and divergent expectations of market participants. This is certainly true for the private debt market where, in many respects, stewardship is in its infancy. GPs interviewed note that there is a significant constraint on the scope for stewardship in markets that are less mature. This was especially observed in the United States, where many sponsors, lenders, borrowers, lawyers and consultants still need education on the scope of stewardship and stewardship tools available in private debt. Raising standards, expectations and skills will be essential to facilitate the delivery of effective stewardship.

As well as raising the standards and expectations of the industry, advocacy and collaborative engagement are important tools to create an aligned approach to stewardship across the asset class. Sustainability and investment professionals at private debt GPs should aim to participate in workshops, summits, initiatives and working groups to share experiences and learn from peers. This will help to increase the broad uptake of stewardship strategies across the market, which will make them more likely to be effective. This will also help to address challenges previously mentioned in this guide of insufficient collaboration between lenders and sponsors and limited standardisation and usability of data.

Acknowledging the overlap between the actions below, we recommend that private debt GPs engage with peers, sponsors, borrowers, regulators, policy makers, standard-setters and data providers to:

- raise industry standards, expectations and skills;
- enhance collaboration and information, data and/or resource sharing;
- improve the standardisation and usability of due diligence data requests and monitoring;
- standardise accepted KPIs and SPTs across sectors and company types;
- encourage the selective adoption of stewardship tools, such as sustainability-related margin ratchets, where implementable and impactful.

CASE STUDY:

ALTERNATIVE CREDIT ESG GROUP

Engagement with peers to discuss sustainability trends and insights can be a powerful tool to collectively lift the standards of the industry. The Alternative Credit ESG Group provides an example of such an effort by private debt GPs.

The group was initially established in 2020 for compliance and legal specialists responsible for sustainability, focusing on the implementation of the SFDR. Over time, it has evolved to include dedicated sustainability staff as companies have expanded these roles.

The group represents more than 15 credit fund managers, with typically around 10-20 attendees at its quarterly in-person meetings. Regular discussion topics include regulation (e.g., SFDR, the Corporate Sustainability Reporting Directive and the Task Force on Climate-related Financial Disclosures), macro sustainability themes, reporting and approaches to data and metrics. The group's purpose is to provide a platform for peers to discuss best practice approaches to a range of sustainability topics, fostering networking across the industry. The benefits to GPs include learning from peers' experiences and discussing approaches to industry-wide sustainability challenges.

Table 3: Applicability of stewardship tools

Sharing resources and providing training	These tools are designed to support value preservation at the borrower and encourage good corporate practice. They should be available to and employed by all private debt investors.
Ongoing dialogue and engagement	
Sustainability-related covenants and margin ratchets	These tools aim to help lenders manage and mitigate material sustainability risks and contribute to value creation. They are more resource intensive and may only be effective in certain markets and where lenders operate further along the spectrums of influence.
Advocacy and collaborative engagement	

ESCALATION

Escalation, the increasingly assertive approaches an investor can take if initial stewardship actions are unsuccessful, is usually an important stewardship tool for investors. However, given the lack of maturity of stewardship within private debt and the nature of the asset class (which involves lending rather than owning), none of the GPs interviewed had formal escalation policies in place.

This guide therefore does not include escalation as a fifth stewardship tool for private debt GPs but, instead, notes where escalation can be effective in relation to the other four tools and the stewardship lifecycle. This is most notably the case when, for example, legally binding SPTs or KPIs are agreed, or if the borrower is looking to refinance.

As practice develops, it is likely that more investors may consider the need for formalised approaches to escalation.

PRIORITISATION OF ENGAGEMENT TOPICS

When using the stewardship tools outlined in this guidance to engage with sponsors and portfolio companies, GPs can use the following criteria to determine the issues to prioritise. Engagement, as part of a wider approach to investment, should ultimately be driven by materiality, with top-down firm priorities and regulatory obligations as additional inputs.

Materiality	Using analysis and data, materiality frameworks and tools, and conversations with sponsors and borrowers to identify what sustainability topics are most material to the borrower. A third-party consultant may be used to assist with this materiality assessment. Responding to material incidents at the borrower – for example, reacting to a cyber-attack at a portfolio company by engaging on improving processes and mechanisms to enhance cyber security.
Firm priorities	Developing a top-down engagement prioritisation framework based on broad sustainability issues and informed by clients' priority topics. This most commonly comprises a portfolio-wide assessment of climate risk, with action taken based on the results. Water use, inclusive employment practices, human rights and labour rights were also referenced by GPs as top-down firm priorities.
Regulation	Engaging with sponsors and borrowers to ensure they can fulfil their regulatory reporting obligations. This is most common in Europe, for example in relation to the SFDR Principle Adverse Impact indicators.

INTEGRATING STEWARDSHIP INTO THE INVESTMENT LIFECYCLE

The four stewardship tools identified can be used by private debt investors at the key stages of their investment process – origination, due diligence and investment approval, holding period and exit – to improve the effectiveness of the stewardship effort and mitigate risk.

Figure 7: Stewardship activities across the private debt investment lifecycle

1. Origination

Establish systems that facilitate efficient and effective stewardship upon deal sourcing

Stewardship and sustainability skills

- Carry out internal training
- Participate in industry events and initiatives on sustainable investment

A framework-based approach

- Create materiality framework templates including KPIs and SPTs
- Draft standardised sustainability clauses

2. Due diligence and investment approval

Systematically integrate stewardship

Due diligence

- Produce sustainability DDQ aligned with industry standards
- Conduct due diligence using internal resource or third-party providers

Engagement

- Align approach with sponsor
- Ensure borrower understands sustainability priorities

Tools

- Draw up sustainability-related convenants, ratchets and action plans

3. Holding period

Share resources, improve data quality and availability and utilise stewardship tools

Education

- Share resources and provide training on material sustainability risks and opportunities

Engagement

- Address management of sustainability-related risks with the borrower and sponsor
- Utilise sustainability-related convenants and margin ratchets to assist the engagement effort

Data

- Support with sustainability data collection and monitoring
- Collaborate on sustainability data and oversight with sponsor

4. Exit

Further develop stewardship efforts and escalate where necessary

Re-financing

- Re-engage on material sustainability risks and opportunities and the borrower's sustainability strategy going forward
- Leverage progress to implement more advanced practice such as ratchets
- Escalate by denying debt if there is a strategy misalignment or unmanaged material sustainability risk

1. ORIGINATION:

Although referred to as origination, this stage involves ongoing actions by GPs to embed stewardship into the deal lifecycle. It includes internal efforts at the GP to ensure that, when a deal is sourced, the GP is in a strong position to exercise stewardship effectively, even when time and resources are constrained.

It also covers wider industry and stakeholder engagement to increase the likelihood that the GP's stewardship approach is aligned with industry practice. The opportunity during this stage is to establish systems that facilitate efficient and effective stewardship upon the sourcing of a deal., principally by ensuring the GP is well placed to educate and advise the borrower (Tool 1) and by engaging with the broader industry (Tool 4).

Despite challenges faced by GPs to embed stewardship in their processes, for example from limited resources and a lack of standardisation of guidance, actions in the table below are applicable for most GPs.

Standard practice	Leading practice
Carry out internal sustainability training. Ensuring investment teams are well trained on sustainability will be an important factor in determining the success of the GP's stewardship approach. Prepare template training materials on sustainability-related KPIs, SPTs and sustainable investment topics. Participate in workshops, webinars and summits on sustainability-related topics. Participate in sustainability-related industry initiatives.	Create materiality framework templates to establish material sustainability KPIs and SPTs upon deal sourcing. Having a framework and clear rationale for selecting material sustainability-related KPIs will improve engagement at the due diligence stage. Draft standardised sustainability clauses to include in loan or deal documentation. Host workshops, webinars and summits on sustainability-related topics. Lead sustainability-related industry initiatives.

2. DUE DILIGENCE AND INVESTMENT APPROVAL:

Considering sustainability factors in due diligence has become commonplace in private debt, as it improves investors' understanding of potential risks and opportunities at the outset of the deal. It also ensures that the borrower is aware of the GP's approach to sustainability and is more likely to understand the need for, and value of, future sustainability-related requests.

Engagement with borrowers at this stage can be very effective, as this is when a lender has most leverage, can set out the terms of the relationship and can ensure alignment on sustainability objectives throughout the holding period. Some investors, operating further along the spectrums of influence, can utilise tools 1, 2 and 3 during due diligence and investment approval. This may include conducting full sustainability due diligence, engaging with the borrower and/or sponsor, selecting sustainability KPIs to prioritise and incorporating margin ratchets and covenants terms in loan documentation.

However, there are also challenges to stewardship during the due diligence and investment approval stage, and how much an investor can accomplish will depend on the nature of the deal. In a highly competitive deal with constraints on time, resources and the GP's ability to obtain information and data, engagement at this stage may be limited to assessing a company's most material sustainability risks via a due diligence questionnaire. Even in constrained circumstances, however, lenders can aim to have a conversation with the borrower and/or sponsor at this stage on their approach to sustainability, helping to prepare for further engagement after the deal has closed. A common approach to Tool 3, for example, is to include standardised sustainability clauses in loan documentation, with the specific terms to be finalised after the deal closes.

Standard practice	Leading practice
Ensure the borrower completes a sustainability due diligence questionnaire, aligned with industry standards.	Commission third-party providers and consultants to assist with sustainability due diligence and monitoring.
Engage with the sponsor/borrower on the GP's approach to sustainability.	Conduct desk-based reviews and site visits to complement the assessment of sustainability-related KPIs and SPTs.
Propose the inclusion of a sustainability-related covenant in loan/deal documentation.	Engage with the sponsor/borrower on material sustainability risks and opportunities.
Propose the inclusion of a sustainability-related margin ratchet in loan/deal documentation.	Finalise sustainability-related covenant terms in loan/deal documentation.
	Finalise sustainability-related margin ratchet terms in loan/deal documentation.
	Establish a sustainability-related action plan with the sponsor/borrower.

3. HOLDING PERIOD:

During the holding period, private debt GPs adopt various approaches to engagement with borrowers. Some limit their engagement to an annual sustainability survey, while others use the holding period as an opportunity to share resources, improve data quality and availability, and nudge behaviours rather than attempting to directly influence outcomes. Some GPs go further, attempting to influence change, often using more formal stewardship tools, such as margin ratchets, as a focal point for engagement.

It is good practice in terms of value creation and risk mitigation for GPs to engage with borrowers and/or sponsors at least twice a year on material sustainability risks, using tools 1 and 2 to ensure borrower and/or sponsor alignment on sustainability objectives. GPs can then aspire to complete the leading practices in the table below, depending on their resources and influence.

Standard practice	Leading practice
Share sustainability resources with and conduct regular training for borrowers/sponsors.	Host training bootcamps and training programmes for portfolio companies.
Engage with the borrower/sponsor on management of sustainability risk.	Support the borrower with third-party verification of data.
Support the borrower with sustainability data collection and monitoring and collaborate on sustainability data and oversight with the sponsor.	Finalise sustainability-related margin ratchet and/or covenant terms in loan documentation.
Track portfolio sustainability data for monitoring and reporting.	Carry out bespoke proprietary sustainability scoring and benchmarking for each portfolio company.
Monitor and track engagements with the borrower and sponsor.	

4. EXIT/REFINANCING:

Only 16% of the lenders surveyed said they undertake stewardship activities during exit, as opportunities for stewardship at this point can be limited, especially where borrowers are not seeking multiple rounds of financing. However, when possible, refinancing presents an important opportunity for lenders to re-engage with the company on its material sustainability risks and opportunities and sustainability strategy.

In such cases of refinancing, lenders can leverage actions from the due diligence and investment approval section and, if previous stewardship efforts have been effective, poor sustainability data and information may be less of a barrier during this stage. Some GPs, for example those doing direct lending to younger companies, implement sustainability-related covenants during their first round of financing to establish key data points from which to set SPTs and associated margin ratchets in a second/ subsequent round of financing.

Upon exit, if there is a misalignment between the lenders' expectations and borrower actions, then potential escalation may involve denying further debt to the borrower.

STEWARDSHIP RESOURCING FOR GENERAL PARTNERS

Integrating sustainability expertise within the investment function is crucial. Staff with sustainability expertise should work closely with investment teams to ensure effective stewardship. Sustainability should be considered a core component of the investment process, not separate from it.

INTEGRATION OF SUSTAINABILITY EXPERTISE

The consensus on an effective approach to sustainability resourcing has evolved over time. In the past, there was a strong emphasis on dedicated sustainability resourcing, which sometimes led to a separation between sustainability and investment teams. While dedicated sustainability expertise remains best practice and underpins the GP's ability to exercise effective stewardship, most investors now recognise the importance of integrating sustainability capacity with the investment function. This integration, through cross-team engagement or having the sustainability team as a subset of the investment team, facilitates the successful implementation of the asset class-specific tools discussed in the guidance.

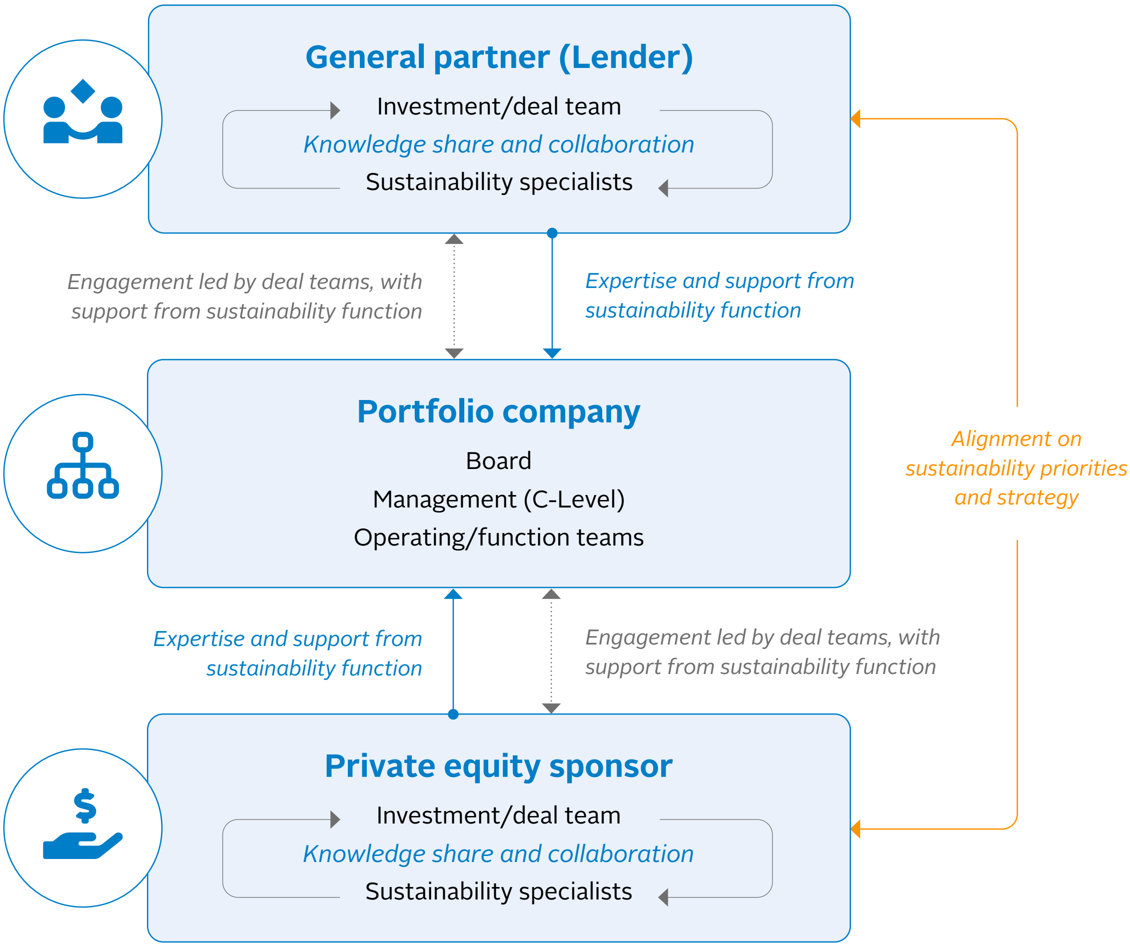
Some GPs rely on external consultants for sustainability due diligence and monitoring. While it can be effective, this approach limits the potential to improve the sustainability skills of the investment team and its ability to engage with borrowers effectively and should not be a replacement for internal sustainability resource. As evidenced from the interviews with practitioners, the most effective engagements are conducted by well-trained investment teams supported by a sustainability function. Managers refer to this as a hub and spoke model, which efficiently uses resources to enable impactful engagement.

GPs should aim to establish a robust accountability structure for stewardship and sustainability. Aligning compensation with sustainability KPIs for the investment team and senior leadership can help provide this accountability. Ensuring that sustainability considerations are part of the investment committee approval process is another. The investment committee should be ultimately accountable for sustainability issues. Ideally, it should include sustainability expertise, especially where sustainability is an important component of the investment strategy. As an alternative, having a sustainable investment expert outside of the investment committee, but with a right of veto related to sustainability factors, can also be an effective approach.

Finally, legal teams should be well trained on sustainability, particularly regarding environmental and social regulations across the different jurisdictions of operation and investment. They should be involved throughout the due diligence process, especially when sustainability is incorporated in loan documentation.

LEADING PRACTICE: Sustainability considerations are fully factored into the due diligence and monitoring process, owned by the investment team itself with support from the sustainability team/resource.

Figure 8: Stakeholders involved in a typical private debt deal where the GP is the sole lender



SUSTAINABILITY TRAINING

When designing sustainability training for investment teams, it's crucial to outline its purpose and value, such as value creation, risk mitigation and/or regulatory compliance for investee companies. Training should be systemised (to a degree), frequent and aim to address specific sustainability challenges. It should be ongoing to ensure investment teams are well equipped to handle evolving sustainability matters. Various formats can be used, including webinars, lunch and learns, newsletters and learning-management systems. Some managers run quarterly sustainability quizzes to engage the whole firm, helping to garner buy-in across teams, and may also bring in external experts at least annually to deliver training. While there are many different approaches to effectively training investment teams, training that is too infrequent or too generic tends to be ineffective.

At a minimum, investment teams should receive mandatory annual training on regulations (e.g., SFDR, the Corporate Sustainability Reporting Directive), engagement strategies, sustainability data, KPIs and SPTs and core sustainability topics such as decarbonisation. This can be conducted by the sustainability team at the GP or an external provider.

LEADING PRACTICE: Systemised, regular, targeted, mandatory training for investment teams on regulation, engagement, sustainability data, KPIs and SPTs, and core sustainability topics.

CONSIDERATIONS FOR LIMITED PARTNERS

LPs play a crucial role in ensuring effective stewardship of their assets through active engagement with private debt GPs. They can integrate sustainability factors into due diligence, use side letters for formal commitments, provide education and resources, request specific sustainability data and collaborate with stakeholders.

Limited partners (LPs) are the ultimate providers of capital to borrowers, via their commitments to GPs. They can engage with GPs to effect change among borrowers, despite being further from the actual operations of the underlying investee companies.

LPs have their own spectrums of influence, similar to GPs, that may impact their ability to exercise stewardship at the GP level. The influence of LPs is impacted by size of investment, timing of investment (with most influence at first close) and type of investment (whether direct, co-investment or through secondaries).

For more detail on how LPs can exercise stewardship in private markets, we recommend referring to the comprehensive Roadmap for Environmental, Social & Governance provided by the Institutional Limited Partners Association. It offers case studies and practical steps that LPs can take across five key pillars of private market investing, covering:

- organisational policy and infrastructure
- due diligence and investment decision-making
- managing GP relationships
- reporting and benchmarking
- internal and external communications

We also recommend reviewing the Net Zero Asset Owners Alliance Call to Action to Private Market Asset Managers, which focuses more explicitly on expectations of managers on climate integration, GHG transparency, net zero targets and financing the transition.

In addition to these resources, however, our dialogue with leading practitioners has identified some of the most effective actions that LPs can take to influence corporate behaviour positively through active engagement with private debt GPs:

1. **Due diligence and side letters:** LPs can integrate sustainability factors into their due diligence of GPs to ensure potential investments align with sustainability goals. LPs can set minimum sustainability expectations for their investments, such as requiring the GP to have an appropriate sustainability policy in place, with failure to meet these expectations deterring investment. Using side letters is another effective tool to formalise sustainability commitments and expectations of GPs.

2. **Educational efforts and resource sharing:** Providing education and consultancy services and sharing resources can be an effective way to help smaller GPs understand and implement sustainability practices.

3. **Monitoring and reporting:** it is important for LPs to be specific and targeted in the data they request from managers and to ensure that GP deal teams understand the importance of sustainability to the LP. Sustainability data in private markets is improving but it is still a developing area: quality and materiality matter more than quantity. There is a need to balance the value-add of data collection – and the benefits of being able to aggregate appropriate datapoints across portfolios – with the need to not overly burden GPs. Quarterly calls with GPs can provide useful touchpoints to ensure the LP understands the actions being taken and the data being collected on its behalf. GPs may also provide an annual sustainability report to LPs, detailing sustainability matters relating to each portfolio investment for the prior 12 months, including implementation of the GP's sustainability policy across portfolio investments.

4. **Stakeholder collaboration:** Such collaboration can leverage the collective influence of the LP and GP community to align and advance stewardship practices in private debt. Advocating for better standardisation and comparability of sustainability data to improve transparency and accountability should be a principal focus of collaborative engagement.

5. **Flexibility and adaptability:** It is important for LPs to be flexible and adaptable when engaging with GPs. GPs in different geographies and of different sizes are taking a wide range of approaches, as we have outlined in this guidance. A uniform approach will not be appropriate across the board.

Many leading LPs are already working along these lines and setting relevant expectations for their GPs. GPs that are keen to remain in line with market expectations and deliver effectively for LPs would do well to be ready to respond.

CASE STUDY

LP ENGAGEMENT WITH GP

One large European LP, with a global footprint, outlined an example of successful engagement with a US-based energy lender and equity investor. The LP followed its private assets engagement programme, systematically assessing the GP on a pre-selected list of factors ranging from 'sustainability governance' to 'linking climate risk to financial risk' , and identified several shortcomings, including best practices, climate scenario testing, investment evaluation and sustainability risk oversight.

Multiple in-person engagements with the chief operating officer (COO) followed, where the LP was represented by senior individuals from both the private debt and sustainable investment teams. The COO at the GP also involved the GP's chief executive officer who met with the LP's chief investment officer (CIO). Critically, the LP's CIO had good knowledge of the topics and the need for GPs to perform well on them and strongly re-emphasised the importance of the topics raised in this engagement.

The purpose of these engagements was not to dictate to the GP what best practice is, but rather to highlight areas where the LP was unconvinced by the GP's approach and supporting documentation and present an opportunity for the GP to revisit its own processes, strategy and governance to meet the needs of its customer.

The GP has since hired a corporate sustainability officer with veto power in the investment committee and established a sustainability committee. It developed scenario analyses using the Net Zero Investment Framework, a firm-wide carbon model aligned with 1.5°C cases, and sector-specific guidance evaluated by its investment teams. It committed its portfolios to adopt best practices and align with 1.5°C goals. Its unique edge includes a portfolio company sustainability briefing that benchmarks companies against sector competitors across sustainability factors, offering opportunities to identify strengths, engage, troubleshoot and improve performance.

This highlights the importance of systematic engagement and continuous improvement in sustainability practices to enhance sustainability and performance.

LOOKING FORWARD

Private debt is complex and lenders faces barriers to stewardship that do not necessarily exist in other asset classes. The purpose of this guidance is to acknowledge these challenges but emphasise that there are stewardship actions that all private debt investors can take. While stewardship is still under-developed across private debt and is not always a practice associated with the asset class, the industry is progressing and coalescing around good practice. Asset owner LPs are also increasing their expectations of private debt GPs on stewardship and are distinguishing between those that do it well and those that do not. This influence from LPs will be a key factor in advancing market practice.

While this guidance outlines the broad stewardship actions that private debt investors can take across the direct lending spectrum, we recommend that future work goes further into the detail of specific types of investments, with actionable guidance more tailored to different investors and strategies.

Collaboration and alignment on stewardship between lenders and sponsors is not yet commonplace and standardised. We encourage further work in this area to ensure clear lines of communication between the multiple stakeholders in a sponsored private debt deal.

Finally, data in private markets has improved materially over the last few years, but its usability is still developing. We encourage further work to improve data coverage across private companies and to help both private equity and private debt GPs determine which data points are the most financially material across different sectors and company types.

APPENDIX

Throughout this guide, we have offered basic and advanced tools to improve the effectiveness of GPs' stewardship efforts. They are gathered in the table below.

Basic tools	
Sharing resources and providing training	Offer sustainability-related webinars and workshops for borrowers.
	Share results from due diligence questionnaires and sustainability surveys.
Ongoing engagement	Meet with sponsor to establish who the key points of contact are and understand its sustainability objectives.
	Use sustainability due diligence questionnaire as a reference point for engagement.
	Conduct an annual sustainability survey.
	Support the borrower with sustainability data collection and monitoring and collaborate on sustainability data and oversight with the sponsor.
	Track portfolio sustainability data for monitoring and reporting.
	Monitor and track engagements with the borrower and sponsor.
Sustainability-related covenants, margin ratchets and action plans	Educate borrowers on the benefits to them of using these tools and propose inclusion in loan documentation.

More advanced tools	
Sharing resources and providing training	Use internal expertise and/or third-party consultants to support a structured and specific sustainability programme.
	Establish materiality framework templates to determine engagement priorities across the portfolio.
Ongoing engagement	Meet with portfolio company during due diligence to set expectations and understand the company's sustainability practices.
	Co-ordinate with the sponsor and with other lenders on an aligned sustainability approach.
	Conduct regular calls, meetings or site visits to discuss sustainability risks and opportunities and to monitor progress against sustainability objectives.
	Support the borrower with third-party verification of data.
	Carry out bespoke proprietary sustainability scoring and benchmarking for each portfolio company.
Sustainability-related covenants, margin ratchets and action plans	Include sustainability-related covenants, margin ratchets and action plans in loan documentation to address material sustainability-related risks at the portfolio company.
Advocacy and collaborative engagement	Host workshops, summits, initiatives and working groups to share experiences and learn from peers.
	Engage with peers, sponsors, borrowers, regulators, policy makers, standard-setters and data providers to raise the standard of the industry.

CREDITS

AUTHORS:

- Aditya Vikram, PRI
- Daram Pandian, PRI
- Paul Lee, Redington
- Tom Picton-Turbervill, Redington
- Edwin Whitehead, Redington
- Celine Grace Legaspi, Redington

EDITOR:

Mark Nicholls, MRG Comms

DESIGNER:

Mat Wiggins

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

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

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

Principles for Responsible Investment

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