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European Leveraged Finance Association

# ESG Integration in Private Debt – Progress amidst growing pains: ELFA's 2021 ESG in Private Debt Survey

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## Executive Summary

- In the first volume of our Insights Series, exploring integration of environmental, social, and governance (ESG) factors in private credit, The Growth of ESG in Private Debt Markets, we summarised the regulatory and market drivers behind this trend, existing approaches to ESG in deal documentation, and some of the challenges faced by lenders, borrowers and other market participants in the face of ESG's stratospheric growth.
- Our recently conducted ESG Survey in Private Debt was designed to explore the extent to which investors were currently integrating ESG considerations into their credit analysis, to understand their motivations for doing so, and to identify opportunities and challenges facing this asset class.
- In this Insights report, we review the key findings from this survey, which collated views from 32 investors representing 23 organisations.
- The survey results reveal that private credit managers are increasingly integrating ESG considerations into their investment processes, driven in large part by end investor requests for ESG data.
- ESG analyses are also driving investment decisions in the market, with around 90% of respondents reporting that in the last 12 months they have passed on, reduced or sold out of a credit investment entirely due to ESG reasons at least once.
- The results also reveal confusion in the face of regulatory developments, which is exacerbating the impact of the lack of ESG data.
- Whilst borrowers and private equity sponsors that are engaged on these issues, are willing to contribute ideas and solutions, the nascent data collection, reporting methods and fewer resources in private debt markets present unique challenges.
- Informed by these results, ELFA has initiated a number of workstreams for 2022 with a view to raising awareness of these issues, developing educational resources for borrowers and increasing the availability of quality ESG data for private debt market participants.

## Introduction

ELFA's inaugural ESG in Private Debt Survey launched in November 2021 to broaden our outreach on the topic, canvassed views of private credit investors both inside and outside of our organisation to inform our work and to support the growth of ESG in the private debt markets.

The survey, conducted in November 2021, explores themes from our inaugural Insights report on the growth of ESG in private debt markets. The report summarised some of the unique issues facing private debt market participants seeking to engage on ESG. We plan to revisit these topics in surveys periodically, not only to track developments but also to inform initiatives conducted under our Private Debt Committee's ESG workstreams.

The survey revealed that ESG is a core factor in private credit investment processes, though data gaps need to be addressed to support this transition. Regulatory pressures present additional challenges, where a significant percentage of investors believe they are in scope for the Sustainable Finance Disclosure Regulation (SFDR), whilst far fewer of the survey respondents reported having access to the necessary information required for Article 8 fund reporting.

This lack of data is mostly attributed to borrowers' nascent data collection and reporting methods. The lack of resources at the borrower level contribute to this issue, as the typical private credit borrower is usually a smaller business than those issuing public equity or fixed-income instruments.

We believe that by coordination amongst private debt market participants, including investors, debt advisory firms, private equity firms, borrowers and professional trade associations, will help the market overcome some of the challenges to ESG integration in this asset class. As such, our 2022 projects will focus on the issues raised by the survey as described in this report.

ESG integration is quickly evolving in private debt markets, with significant pressure coming from end investors

The private debt market has undergone a seismic shift over the last few years in its approach towards ESG factors. Around 50% of survey respondents incorporate ESG considerations into more than 75% of their firm's private debt AUM.

Further, ESG analysis is increasingly becoming an integral part of private debt managers' investment processes and decisions. For close to 95% of respondents, ESG is very important or extremely important in the credit analysis process – 87% of participants agree that lack of ESG therefore is likely or very likely to be a deal breaker. Around 90% of participants have passed at least once on a deal due to ESG reasons, and for more than 15% of respondents this decision has been taken as many as twenty times or more.

**"[Growth in ESG disclosure] will be driven by requirements from private debt LPs, so if ELFA can help them navigate ESG that would accelerate the process." – Respondent to ELFA's ESG in Private Debt Investor Survey**

## Data availability presents challenges to integrating ESG into credit research

This increased focus on ESG is becoming embedded into private credit managers' investment analyses, where close to two-thirds of survey respondents reporting that the primary way they integrate ESG into their portfolios is through credit research. This exceeds the proportion of respondents using exclusions as their primary approach to ESG investing (23% of respondents), whilst direct engagement with borrowers as the sole method of gathering ESG information, accounted for only 10% of respondents.

This echoes trends observed in the broadly syndicated loan and high yield bond market, explored in our Insights report [ESG Integration in the Leveraged Finance Market – Continued Focus Amidst persistent Data Gaps], published in January, suggesting an alignment in ESG approaches across leveraged finance markets.

Availability of good quality ESG data continues to be the greatest obstacle to comprehensive ESG analyses in these markets, with eighty-seven per cent of respondents flagging that a lack of ESG information or unsatisfactory findings would constitute a deal breaker or could lead managers to turn down opportunities.

This problem is also observed during auction processes where 70% of respondents reported that the information provided is only sometimes or rarely sufficient.

**"The key issue is lack of awareness of ESG by portfolio companies. They will not know how to do GHG emissions calculations and sometimes hiring an ad-hoc advisor is quite challenging." – Respondent to ELFA's ESG in Private Debt Investor Survey**

Private debt investors primarily use internal ESG ratings as part of their ESG approach. This is in part due to the specific nature of private debt funds where deeper engagement with borrowers is more prevalent. Meanwhile, only 6%, always or usually use external ESG research in their process, though the use of external ESG ratings is more common at just above 20% of respondents using this source of information. However, 90% of participants consider external ESG diligence as equally if not very important.

A 70% of our survey respondents reported monitoring borrower ESG KPIs annually, with a few others monitoring data on a quarterly basis.

## Reporting frameworks and standardised data reporting are key next steps to a credible analysis of ESG by investors

Even when borrowers do report ESG data, the lack of standardisation creates challenges in effective use of the data. When private credit investors were asked which of the following frameworks, they consider in their ESG analyses, SASB and the Sustainability Development Goals (SDGs) were the top choices followed by EU Taxonomy.

This is in some ways to be expected as there is currently no official standards board for disclosure and an ever-greater mix of initiatives by market participants is emerging.

There are several projects aiming to address these issues, including the creation of the International Sustainability Standards Board (ISSB), which has merged with the Climate Disclosure Standards Board (CDSB) this year.[1] The organisation will look to consolidate SASB standards and integrated reporting in June 2022, bringing much-needed standardisation to the market.

The ESG Data Convergence project is also another initiative seeking to establish standardisation in data reported from GPs to LPs. ELFA intends to collaborate with these and other organisations on the issues facing the private debt market participants.

**"[ELFA can support improved ESG reporting] by providing best practice examples of disclosure." – Respondent to ELFA's ESG in Private Debt Investor Survey**

Ideas offered by survey respondents to support the growth of ESG investing in private debt markets included:

1. Raise awareness of ELFA's ESG Fact Sheets amongst private debt market participants.
2. Improve the availability of ESG data, including metrics, standardisation and disclosure.
3. Educate market participants on the regulatory requirements present in the asset management industry, especially banks, law firms and borrowers.

## The role of SFDR in private debt markets

The SFDR presents a range of new obligations to encourage more transparency by asset managers on their ESG investments and aims to address greenwashing issues. Investments promoting ESG characteristics (deemed as Article 8 funds) or with sustainable investment objectives (falling under Article 9) will be expected to report specified metrics on their sustainability performance.[2]

While the full text and implementation methodology of the regulation will come into effect from July 2022, market participants expect that disclosure of PAIs will be required for all firms in scope of the regulation, whilst others may follow as a matter of market practice. Regulatory Technical Standards (RTSs) for how disclosures will be made and further instruction on what indicates as PAI is also expected to be clarified in the updated regulation.

[1] Please see CDSB Sunset event and International Sustainability Standards Board.

[2] REGULATION (EU) 2019/2088 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on sustainability related disclosures in the financial services sector

The requirements may look similar to the 18 criteria of the Principal Adverse Sustainability Impact statements in Annex 1 of [ESMA's Final Report on draft Regulatory Technical Standards](#) (dated February 2021). These include criteria such as greenhouse gas emissions (scope 1, 2 and scope 3 from 2023 onwards), gender pay gap and board diversity.

Our survey revealed that at least two thirds of respondents believe that they are in scope for SFDR regulation. When asked which SFDR classification the largest proportion of their private credit funds fall into, 45% of participants cited Article 6.

Alternative funds are expected to have the lowest percentage of Article 8 and 9 funds. This reflects views shared in the survey, with just over 20% reporting holding Article 8 funds and no respondents reporting holding Article 9 funds in their portfolios.

SFDR may support increased ESG transparency with additional reporting obligations being passed on to investee companies as lenders seek to deploy ESG strategies. Indeed, around 52% of our survey respondents plan to move to Article 8 or Article 9 funds.

However, these results come with significant uncertainty from survey respondents about the new regulations – nearly 30% of respondents were unsure whether their firm was in scope for SFDR, and of those not in scope, 42% did not know if their firm would nonetheless report in line with the regulation's requirements.

**"Regulatory requirements [will improve ESG disclosure and transparency in the private debt market], e.g., big private companies might have similar reporting requirements as private companies." – Respondent to ELFA's ESG in Private Debt Investor Survey**

## Putting our survey results into action – ELFA's plans to support the growth of ESG in the private debt market.

Whilst increased engagement by borrowers and private equity sponsors is encouraging, with some showing willingness to provide ESG information, the lack of data is exacerbated by insufficient data collection and reporting methods.

This is in part due to the typical private credit borrower being smaller than those issuing public equity or fixed-income instruments, and as such possessing fewer resources to support this undertaking.

When asked what ELFA could do to support the growth of ESG in this market, 84% of participants cited raising awareness of [ELFA's ESG Fact Sheets](#) amongst private debt market participants. A significant number of respondents also reported that educational resources would be useful to support companies and their advisers. Some of our plans to implement these suggestions are set out below.

**Adding a Chapter on ESG in Private Debt Markets to our Guide for Company Advisers on ESG Disclosure in Leveraged Finance Transactions:** Following engagement with a wide range of market participants, including private equity sponsors, arranging banks, and law firms, during our ESG Workshop for Advisers held in January, our updates to the Guide will include a chapter on ESG in private debt and a chapter on ESG litigation risk. Market participants are welcome to submit suggestions for these chapters to Sabrina Fox, ELFA's CEO, at sfox@elfainvestors.com.

**Forming a Working Group for ESG Data Providers:** This year ELFA is leading a working group that will focus on bringing together ESG data providers with a view to increasing leverage finance coverage and facilitating engagement on the need for increased climate and carbon data reporting. To join this working group, send an email to Sneha Nayak, Research Analyst for ELFA, at snayak@elfainvestors.com.

**Producing Video Glossary on Key ESG Topics for Borrowers of Private Debt:** Given that the typical private credit borrower is a smaller company with fewer resources than larger firms, ELFA is creating an ESG video glossary to explain key ESG topics and why specific ESG information is important to investors, with reference to the information requested in its General ESG Fact Sheet. To submit suggestions on this workstream please send an email to Sneha.

**Updating our ESG Fact Sheets:** We plan to further improve the ESG Fact Sheets by incorporating additional sectors and also by making it easier for borrowers to discern when investors want quantitative versus qualitative disclosures. If you have suggestions for additional sectors, we should cover, or on the ESG Fact Sheets themselves, send them to Sneha.

**About ELFA:**
ELFA is a professional trade association comprised of European leveraged finance investors from over 50 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA's website: www.elfainvestors.com.