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European Leveraged Finance Association

ESG Reporting and Engagement at the LP/GP Level for Private Debt Funds

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INSIGHTS

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Executive Summary

- ELFA recently hosted a workshop for members of the Private Debt Investor Committee, who were joined by investment consultants from Hymans Robertson and Cambridge Associates.
- At the workshop participants considered ESG reporting, specifically disclosure under the Sustainable Finance Disclosure Regulation (SFDR) needs at the LP/GP level.
- Some of the key takeaways are summarised in this report.
- With regulations such as SFDR having an impact on ESG reporting, LPs and GPs should have a clear environmental, social and governance (ESG) framework at the firm level and product level.
- The framework should ensure fulsome and regular disclosure and reporting of ESG data by borrowers.
- Participants noted that smaller companies lack the sufficient resources to comprehensively measure and report ESG data.
- Engagement serves as a tool to advise borrowers on how to advance performance on short, medium- and long-term timescales. This allows lenders to understand ESG risks using deeper qualitative insights from borrower management teams or their sponsors.
- Resources such as questionnaires like ELFA's ESG Fact Sheets, can be a starting point for companies who are guided to disclose and engage on ESG topics.

Introduction

ELFA recently hosted a workshop for members of the Private Debt Investor Committee who were joined by investment consultants from Hymans Robertson and Cambridge Associates to discuss environmental, social and governance (ESG) related topics for private debt funds. The workshop featured interactive discussions about engagement and ESG reporting, specifically Sustainable Finance Disclosure Regulation (SFDR) reporting needs at the LP/GP level.

With the acknowledgment that ESG has become a key part of the investment analysis, both ELFA members and investment consultants noted that there should be a greater focus on the quality of ESG data reporting in private debt funds. While regulations such as SFDR may be key drivers towards greater data transparency, smaller companies lack the sufficient resources to comprehensively measure and report ESG data. Members highlighted the need for engagement tools and using resources such as questionnaires as a starting point for companies who are guided to disclose and engage on ESG topics.

The impact of regulatory categorisation on ESG reporting

The investment consultants and ELFA members started the discussion with SFDR, which was implemented by the European Commission in March 2021[1] and aims to attract private investment to support the transition to more sustainable investments by providing transparency about sustainability risks.

SFDR categorises funds as Article 6, Article 8, or Article 9. Article 8 and Article 9 funds are financial products that have different levels of sustainability criteria. Article 9 funds make sustainable investments their objective and asset managers disclose how their investments are environmentally sustainable to end investors. Article 8 funds may include investments that do not necessarily contribute to sustainable objectives but have an ESG focus.

Investment consultants highlighted how there are different approaches when choosing Article 8 funds, and some are more well considered than others. Managers should review the requirements for Article 8 or 9 funds when it comes to ESG data reporting before deciding which category to choose.

Integrating ESG into the investment analysis is necessary at the firm and product level

Participants also discussed what LPs look for when considering ESG. When integrating ESG into the investment analysis, investment consultants highlighted that ESG procedures should be credible.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088

When looking at the environmental element, LPs expect GPs to have a net zero objective. The form of commitment towards net zero can be addressed at the firm level by looking at the firm's carbon footprint and then the portfolio companies' goals to achieve net zero.

The investment consultants also noted that the social element has made progress with schemes such as the UK government's levelling up agenda which aims to improve opportunities and prosperity for everyone across the country by 2030.[2]

There has also been progress on engagement and data on social matters because of the changing international norms and expectations which go beyond the UK's levelling up agenda. There are expectations for active management of human rights challenges, retaining and upskilling human capital and ensuring equality and diversity. All these expectations are now considered when managing employees and they are some of the stakeholder and regulatory pressures which borrowers and their lenders may encounter.

With regards to governance, it is generally always considered as a given as investments have always had a governance focus.

The use of an external ESG ratings agency is also useful to contribute to the credibility of the ESG process. This reassures investment consultants as it shows that the asset manager is well resourced, up to date with regulations and other requirements and can apply a level of consistency across all the assets.

At the product level, investment consultants aim for materiality to be clearly stated during the reporting process. Reporting of materiality is important because it helps investors understand the asset manager's ESG strategies. Within private debt, the big challenge is that smaller companies may be unable to measure and provide more reporting of ESG data. However, members noted that there has been progress in the reporting of ESG data with the help of Sustainability Linked Leveraged Loans[3] (SLLLs) and/or ESG margin ratchets which sets objectives to report against. However, compared to other asset classes private debt still has a long way to go when it comes to ESG data reporting.

Engagement as a tool for better access to ESG data reporting

The nature of the private debt market means that lenders have a direct relationship with borrowers. This can help increase ESG reporting but is not a panacea due to resource constraints of the borrowers.

For smaller borrowers, workshop attendees noted that they may not wish to see reporting entirely displace directive action on material ESG risks and opportunities. The opportunity cost of dedicating resource to KPI measurement and reporting production could mean that not enough focus is placed on what makes the borrower more financially or risk resilient, including having ESG issues better managed.

Thus, workshop attendees noted that in the absence of ESG data in the short-term, engagement serves as a tool for lenders to advise borrowers on how to advance performance on short-, medium- and long-term timescales, particularly where a borrower has defined ESG objectives. Whilst data on material ESG reporting can be one of these objectives, it could be balanced with real-world ESG risk and opportunity management/improvement carried out at the same time by the borrower. Engagement also helps lenders understand ESG risks by using deeper qualitative insights from borrower management teams or their sponsors.

A clear and specific engagement framework should be applied within private debt to involve borrowers more. Investment consultants look for 'escalation strategies' from asset managers which involves setting meaningful objectives with their portfolio companies, making clear what the business plan is and asking questions such as whether it is fit for purpose and material.

Engagement resources such as questionnaires are helpful to ensure that ESG data is disclosed. ELFA's ESG Fact Sheets are an example of these resources that can serve as a useful starting point for ESG discussion to help streamline the disclosure process for borrowers.[4]

Conclusion

As regulations such as SFDR continue to develop, LPs and GPs can ensure they consider all the requirements for Article 8 and 9 funds under SFDR by developing an internal ESG strategy at the firm and product level. Engagement with borrowers acts as a tool to access better ESG data and serves as a tool to advise borrowers on how to advance the timescale of borrowers' ESG objectives. Using resources, such as ELFA's ESG Fact Sheets, can help improve the quality of ESG data reporting in private debt funds.

[2] Government unveils levelling up plan that will transform UK - GOV.UK (www.gov.uk).
[3] ELFA-Best-Practice-Guide-to-Sustainability-Linked-Leveraged-Loans-1.pdf (elfainvestors.com).
[4] ESG Fact Sheets - European Leveraged Finance Association (elfainvestors.com).

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. 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 ELFA's website: www.elfainvestors.com.

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