Pushing the Envelope: ESG Integration in Private Credit

A publication of the
LPEA Private Debt Technical Committee

About LPEA

The Luxembourg Private Equity and Venture Capital Association (LPEA) is the most trusted and relevant representative body of private equity and venture capital practitioners with a presence in Luxembourg. Created in 2010 by a leading group of private equity and venture capital players in Luxembourg, with more than 547 members today, LPEA plays a leading role locally actively promoting PE and VC in Luxembourg. LPEA provides a dynamic and interactive platform, which helps investors and advisors to navigate through latest trends in the industry. International by nature, the association allows members to network, exchange experience, expand their knowledge and grow professionally attending workshops and trainings held on a regular basis.

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Executive Summary

Following its insightful article on Sustainability-linked Loans in Insight Out #28, the LPEA Private Debt Committee presents an extensive dossier that further explores the link between Private Credit and ESG. This publication contains a range of in-depth articles from the European Investment Fund, I4B, A&O Shearman, and Ogier, sharing their expert insights on the topic.

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Investor view: Private Credit - Move Towards Sustainability

Priscilla Schnepper
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General introduction on sustainability

Sustainability has become increasingly important in the general investment space. The overall spectrum of ESG is wide, in the same way as topics covered under its umbrella. The European Commission explains sustainable finance as referring to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and products. Environmental considerations may include climate change mitigation and adaptation, as well as e.g. the preservation of biodiversity, pollution prevention or the circular economy. Social considerations can include inequality, inclusiveness, labor relations, investment in people and their skills and communities and human rights issues; governance factors look at, inter alia, an entity's governance (including employee relations, management structures, executive remuneration).

Sustainable finance is understood as supporting economic growth while reducing pressures on the environment to help reach the climate and environmental objective of, inter alia, the European Green Deal including the legally binding target for Europe to be climate-neutral, implying no net emissions of GHG, by 2050. The transition shall be just and fair; economic growth shall be decoupled from resource use and ensuring that no person and no place is left behind[1].

While sustainability encompasses the environmental, as well as the social and governance aspect, with the European Green Deal and the corresponding EU regulation, , inter alia latest EU taxonomy delegated acts, reporting requirements, such as the CSRD (ESRS reporting for companies) and SFDR (for market participants, such as investment funds), macroeconomic developments leading the way to the desired energy independence, the environmental aspect has been taking a primordial role. In order to achieve the current climate target for 2030, the European Commission estimates additional annual investments of c. EUR 260bn. The urgency of acting upon the climate question and abandoning the business-as-usual scenarios, which would, in line with current research, inevitably lead to a global temperature increase above sustainable levels for the planet and its inhabitants. Current policy scenarios are not considered sufficient to reach the target of the Paris Agreements to limit global warming to 1.5 degrees above pre-industrial levels[2] .

The World Economic Forum explores the most severe risks humanity may face in the coming two to 10 years. The 2024 report[3] includes environmental, societal, economic, geopolitical and technological risks. The list of the 10 most severe risks over the coming ten-years' horizon is initiated by 4 environmental risks (environmental risks amounting to five out of ten), which are extreme weather events (physical risks), critical changes to the earth's systems, biodiversity loss and ecosystem collapse, natural resource shortage and pollution.

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[1] Overview of sustainable finance - European Commission (europa.eu)

[2] As per the IEA's World Energy Outlook 2023, consider the current policy scenario leading to a temperature increase of 2.4 degrees in 2100 (and 1.9 in 2050). "Tripling renewable energy capacity, doubling the pace of energy efficiency improvements to 4% per year, ramping up electrification and slashing methane emissions from fossil fuel operations together provide more than 80% of the emissions reductions needed by 2030 to put the energy sector on a pathway to limit warming to 1.5 °C".

[3] The Global Risks Report 2024, 19th Edition - Insight Report - World | ReliefWeb

Economic, technological, geopolitical and societal risks are also part of the risks faced in the coming two years. On the long-run, societal risks (involuntary migration and societal polarization) will be faced, as well as technological risks evolving around mis- and disinformation, AI and cyber insecurity.

The Stockholm Resilience Centre, a team of scientists defined nine planetary boundaries (parameters), which are considered crucial for the earth's well-being. As of 2023, six out of these, nine boundaries are considered exceeded. Crossing boundaries increases the risk of generating large-scale abrupt or irreversible environmental changes. While drastic changes are unlikely to occur over night, together the boundaries mark a critical threshold for increasing risks to people and the ecosystem humanity is part of.

In addition to the above, today's generation is living in a dynamic society subject to evolving influences, socio-economic trends, macropolitical developments or changes in lifestyle and preferences, which directly affect business and investment decisions. The analysis of global megatrends for the purpose of strategy planning supports in anticipating and responding to upcoming dynamics. According to the "Zukunftsinstitut", current megatrends shaping our society include a gender shift, focus on health, globalization, connectivity, individualization, security, new work, neo-ecology and the overall increased life expectancy to mention a few[4] . Businesses and investors operate within these societal trends and cannot but take them into account, from a risk, as well as opportunity perspective. Reflection is found in company's internal factors, such as the working standards and conditions, gender balance or labor standards, as well as external factors affecting inter alia social aspects the company's supply, client or other stakeholder interests. Furthermore, the political environment and dynamics can have wide-ranging effects on a company's operations.

Finally, there is a deep inter-connection between climate and social risks (comparable to a double materiality of intertwined social and environmental risks): On one side of the coin, climate change will inevitably have social consequences linked to factors ranging from heat risks to human health or food production impacts, such as mass migration, risk of higher mortality due to extreme weather events, social injustice or possible geopolitical impacts.

> Investments in climate sectors are essential, at the level of new technologies, as well as scale up and deployment of existing technologies. Private credit can thus address a market opportunity and financing need underserved by other market participants.

Overall, as stated in the IPCC's AR6, communities and nations, which contributed less to the climate change are more negatively affected. On the other side of the spectrum, poverty, lack of resources, inequality and injustice hamper the advancement of necessary climate mitigation (and adaptation) measures. Climate change is a world-wide environmental and social phenomenon, siloed responses on a limited geographical level will not solve the global challenge.

From an investment perspective, such considerations may deeply affect the future risk-return profile and are to be considered an integral part of the investment process for the purpose of identifying and considering related risks and opportunities.

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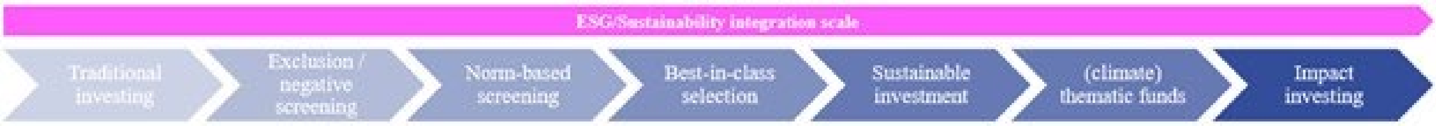
[4]The Megatrends (zukunftsinstitut.de)



Sustainability in Private Credit – more than risk assessment

As can be deduced from the above overall situation, all economic activity is expected to be in some way or another affected by ESG and specifically climate considerations. The following ESG integration scale illustrates the spectrum of possible approaches:

While the European private credit market has surged mainly after the Global Financial Crisis, sustainable, transition and impact private credit funds reflect a recent development nurtured by, inter alia, the increasing environmental and social awareness, EU Regulation, as well as associated pressure from LPs to implement sustainable strategies (including the EIF). Increasing focus is paid to climate and environmental solution thematic areas such as mobility and transport solutions, energy and built-environment solutions, industrial decarbonisation, sustainable agriculture, blue economy and other adaptation solutions, with high development potential remaining. On the social side, diversity, work-force related aspects or effects on the local community are some of the aspects typically considered.

In the current market development, risk factors, which used to be incorporated for a general risk analysis tend to now be considered within the category of ESG (e.g. governance structure, management practice, employee policies, etc.). Additionally, these analyses are typically further complemented and enhanced to emphasize and contribute to a fair transition. From an environmental perspective, the assessment of physical, as well as transition risk is of fundamental importance, especially in view of the long-term investment nature of private credit. While physical risks look at immediate damages through extreme natural events (acute or chronic), transition risks address the question of changes in respect of, inter alia policy and legal, technology, markets or reputational aspects, which may substantially affect companys' financing options and valuations.

> “According to the International Energy Association, reaching the targets until 2030 under the Paris Agreements relies mainly on the upscale of existing technologies, while the targets until 2050 require the development of additional technologies, such as carbon capture and storage technologies, hydrogen-related technologies, just to mention a few.

(Sustainable) Private Credit financing opportunity

The demand for sustainable debt financing, i.e. debt products specifically focusing its investment strategy on sustainable thematics, is embedded into a general financing need for non-dilutive products addressing a market gap between equity or venture capital and traditional bank financing or liquid markets.

In the sustainable finance space (with a focus on environmental sustainability), private credit can address a wide range of sectors and debt strategies, including:

- debt financing to growth companies developing climate and environmental solutions (e.g. water treatment solutions, digital solutions, renewable energy technologies, battery development, innovations relating to circular economy, etc.) after initial equity-only and/or grant finance

- specialist financing targeting (small-scale) renewable energy or energy efficiency projects addressing a market need for bridge financing (for the construction stage) and granular long-term financing solutions (energy efficiency projects)
- debt financing in the agricultural sector to support, inter alia, the transition to sustainable agriculture, investments linked to decarbonization, etc.
- debt financing to support the circular economy and corresponding investments
- decarbonization/energy transition in general by financing investments aimed at substantial emissions reduction or linking financing to specific decarbonization targets
- Addressing relevant social indicators by linking the financing terms to the achievement of corresponding targets or KPIs

Investments in climate sectors are essential, at the level of new technologies, as well as scale up and deployment of existing technologies. Private credit can thus address a market opportunity and financing need underserved by other market participants.

According to the International Energy Association, reaching the targets until 2030 under the Paris Agreements relies mainly on the upscale of existing technologies (such as renewable energy, electric vehicles, grid development, or energy efficiency investments (e.g. heat pumps)), while the targets until 2050 require the development of additional technologies, such as carbon capture and storage technologies, hydrogen-related technologies, battery improvements, just to mention a few. Even though important investments are being carried out, the investment gap remains substantial – energy investments in the EU will have to reach EUR 396bn per year from 2021 to 2030 and EUR 520-575bn per year in the subsequent decades until 2050[5].

While the above has been focused on environmental aspects, aligned with the target of a fair transition, private credit investments shall equally ensure minimum safeguards and actively contribute to social improvements, such as diversity, equal opportunities or improved labor conditions.

History, data availability & quality

Even though first scientific findings linking climate change to economic activity, such as the contribution of chemical CFCs to the decomposition of the earth's ozone layer in the 1970s, climate awareness and its translation into the business world has taken its time. Over the years and integrating further research, progress has been made, culminating in some of the most well-known climate milestones, the Kyoto Protocol or the Paris Agreement and related National Defined Contributions. Tackling environmental and social challenges the United Nations have defined the Sustainable Development Goals, for whose achievement more than EUR4 trn still need to be invested world-wide.

Such recent surge of ESG and climate-related awareness results in a need and search for relevant and harmonized data to facilitate informed investment decisions. Increased disclosures lead to increased awareness, data availability and understanding of ESG-related risks and opportunities. To effectively address a social or environmental objective, intervention parameters are to be established based on the current situation and future targets reflecting a preferred or desired outcome.

Challenges include the availability of data, the harmonization of data, the completeness of reported data, the decision usefulness of contributed information, the complexity of data compilation (e.g. Scope 3 emissions) and related costs, underlying assumptions taken, evolving regulatory requirements, as well as over-or understatement of relevant information.

Green- or ESG washing, which has become a widely known term in recent years, goes hand-in-hand with the increased focus on sustainability. Companies or market participants may be tempted to overstate green initiatives and/or understate or omit certain investments or activities. Based on a recent report from the EBA, the alleged incidents of misleading communication on ESG-related topics more than tripled between 2019 and 2022, of which c. 30% corresponding to environmental or climate-related topics[6].

Important steps have however been taken in the recent years towards a more detailed and harmonized data landscape.

[5]Energy transition in the EU (europa.eu)
[6]EBA progress report on greewnwashing.pdf (europa.eu)

A number of initiatives (for companies, as well as for asset managers), globally and at the level of the EU have emerged and partially become obligatory. Such include the TFCD and the ISSB's IFRS S1 and S2 (general disclosure of sustainability-related financial information and climate-related disclosures, including Scope 3 emissions), the SFDR and the EU taxonomy being a front-runner in terms of detail and timing (and other comparable taxonomy initiatives world-wide), as well as the ESRS part of the CSRD requiring a comprehensive set of ESG-related data to be reported annually and taking a double-materiality approach (as the TCFD). From an environmental perspective, the Partnership for Carbon Accounting Financials ("PCAF")[7] provides detailed guidance for each asset class to calculate the financed emissions resulting from activities in the real economy that are financed through lending and investment portfolio.

Data availability is often cited as a challenge, especially in the lower end of the market. This is further accentuated by some of the above-mentioned frameworks applying to larger entities, but providing exceptions or lighter reporting requirements for SMEs, taking into account, inter alia limited resources at smaller company level. As PCAF states, limited data can be a challenge, should however not deter financial institutions to report on financed emissions – estimates can be an appropriate begin. In the private credit space, fund managers leverage on direct access to the company and a unique stand to (i) obtain relevant information and (ii) influence and steer the company towards increased measurement and disclosure.

While acknowledging the overall challenge, LP investors in private credit are invited to critically challenge data collection practices and amounts, encouraging disclosures and support for data collection and direct investments decisions, work with experts in order to maximise the data and its reliability and direct investment decisions based on the comprehensive due diligence information.

The EIF's role and investment focus

The EIF stands at the intersection between the public and the private markets, aiming, amongst others, at developing the market environment, fostering the rise of attractive investment strategies addressing political and policy priorities and ensuring a relevant communication between political actors and the market, reflecting the policy priorities into the market via its investment strategy, while at the same time targeting to invest in high quality players offering attractive return expectations.

> "The private credit tool box entails the unique opportunity to link company-wide objectives to relevant KPIs and their achievement to the applicable interest rate.

Within this spectrum, the EIF's overall objective and mission of catalyzing sustainable and inclusive growth by improving access to risk finance for Europe's businesses converges with the support of the green transition by typically supporting small players and investments in the lower end of the market. The EIF focuses its investment on the lower mid-market aiming at a dedicated support for European SMEs. By definition, the EIF's investments combine a financial and one or several extra-financial investment objectives.

As an EU body, the EIF is taking the forefront in market development, including this dynamic green investment and transition market anticipating additional investors to follow, leveraging on a large and known LP's anchor investment. Private investors are indeed beginning to enter the market (depending also on geographic location), leaving nevertheless an important area of development.

ESG Integration

As a base line, the EIF applies exclusion and ESG analysis and typically requests a similar minimum standard for private credit funds invested into.

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[7]Enabling financial institutions to assess and disclose greenhouse gas emissions associated with financial activities (carbonaccountingfinancials.com)

> To seek unique differentiation and attractive risk-return perspectives, innovative strategies are being explored, identifying un-served financing needs and opportunities.

Further requirements/preferences largely depend on the underlying strategy, product focus ensuring consistency within the parameters and the underlying strategy. Post investment, a comprehensive reporting, including ESG and climate data, contributes to data collection and availability. EIF is a value-driven and responsible market operator, striving to implement best practices across all its business lines and within the organization.

The private credit tool box furthermore entails the unique opportunity to link company-wide (ambitious) objectives to relevant KPIs and their achievement to the applicable interest rate (sustainability linked financing). Advantages include a focus on the entire company and a universal applicability for environmental, as well as social targets. Echoing previous paragraphs, sustainable financing focusing on the purpose of finance can effectively support transition investments or sustainable companies.

EIF's investment process foresees a comprehensive list of ESG and sustainability-specific legal negotiation points, in order to, inter alia, increase (extra-) financial alignment, ensure sound handling of the measurement and reporting associated to (extra-) financial topics; as well as corresponding transparency to Investors. These include a detailed description of the extra-financial strategy and objectives, the methodology of ESG integration and ESG/Sustainability roadmaps where applicable, the coherence of the purpose of finance with the defined sustainability target, independent review/audit function, alignment of interest and performance-based economics and comprehensive reporting to investors.

To complete the picture, in line with current state of play for private credit, the EIF equally seeks to support social and macroeconomic cohesion and fairness, as well as promote new initiatives and strategies addressing social or environmental priorities. This translates into specific policy focus on non-core geographic regions, diversity KPIs at the level of the fund manager, as well as support for first-time managers.

Climate-strategies

The EIF's (private credit) investment are embedded in the EU's overall move towards sustainability and net zero, as detailed in the previous sections. The EIF is part of the EIB, EU's climate bank and one of the world's main financiers of climate action. As such climate-related strategies (supporting inter alia any of the six taxonomy objectives) form an integral and increasing part of the EIF's investment strategy. For detailed examples of investments in the private credit space, the EIF can support, please refer to the above section on sustainable private credit investment opportunities.

It is observed that to date many of the climate-relevant strategies mentioned in the section on private credit investment opportunities originate from Western European countries counting to date on a more developed private credit market and network, however demand for specialist debt financing related to the climate transition has been increasing all over Europe (including Southern Europe and CEE, partially covered by players located in Western Europe). To seek unique differentiation and attractive risk-return perspectives, innovative strategies are being explored, identifying un-served financing needs and opportunities.

Thematic private credit funds addressing the financing gap for climate technologies and scale ups is increasing and private investors adding such strategies into their investment portfolios is essential. From a risk-return perspective, such sustainable private credit investment opportunities can present attractive risk-adjusted returns and contribute to relevant portfolio diversification while contributing to non-financial objectives.

EIF CA&ES criteria for green financing

The EIF climate action and environmental ("CA&ES") criteria are a set of indicators and guidelines that validate the "green" nature of an investment. These criteria are directly inspired by the EU Taxonomy and adapted to the private assets and SME markets. The criteria are built on the six environmental objectives listed in the EU Taxonomy. The purpose of these criteria is to identify investments and/or companies actively contributing to the green transition, while including certain adaptions to SMEs.

The alignment target with the CA&ES criteria are defined prior to the investment a fund and are contractually defined in the legal documentation. Regularly reports are required (before each drawdown and quarterly) on the alignment of the investments with these criteria.

Conclusion

Concluding on the above, the key take outs include the overall shift of private credit towards sustainability, the urgency to act and support a just climate transition, the attractive and relevant role private credit plays in this context and finally the need for increased awareness of attractive financing opportunities.

ESG risk is financial risk and climate risk will sooner or later affect companies' and thus investors' bottom lines. Incorporating an extra-financial analysis and incorporating climate (tech) solutions into the investment portfolio can support to future-proof the investment portfolio and begin to (quoting N. Stern) remedy one of the biggest market failures.

As an EU body and a large European LP, the EIF aims at paving the way at identifying and investing in attractive risk-adjusted return opportunities, while fostering the sustainable development of SMEs in Europe, developing the private credit ecosystem to provide alternative sources of finance and front-run ESG and climate-relevant investment initiatives and other EU policy priorities with the aim to catalyze private capital into attractive investment opportunities serving the common European good.

Navigating ESG Integration in Infrastructure Investments: Embracing Opportunities Amidst Challenges

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Gone are the days when ESG issues were just for a niche group of investors. Now, according to the latest Global Sustainable Investment Alliance (GSIA) report, a whopping $30.3 trillion is invested globally in sustainable assets. More and more investors are taking sustainability seriously.

Infrastructure investments are at the heart of this shift towards sustainability. They're crucial for driving positive change and building a greener future. The Global Infrastructure Hub says we need a massive $3.7 trillion each year until 2035 to meet global sustainability goals. That's a big job, and infrastructure investments are key to making it happen.

Infrastructure is all around us and critical for a sustainable future

Infrastructure encompasses the essential physical and organizational structures and facilities that support societies and economies every day. They encompass a wide range of long-term assets and systems providing essential services, facilitating economic activity, and contributing to social well-being and environmental sustainability.

From roads, bridges, and airports to water supply and sanitation systems, electricity grids, and telecommunications networks, infrastructure assets define modern civilization. Social infrastructure such as schools, hospitals, and community centers guarantee our quality of life, and environmental infrastructure like waste management facilities and renewable energy installations secure the sustainability of our communities.

Double materiality counts, especially as temperatures rise

Given the critical role of infrastructure in shaping communities and economies, integrating environmental, social, and governance (ESG) risk analysis is paramount to creating long-term value and resilience.
One important concept in analyzing the ESG risk of infrastructure investments is double materiality. It's not just about how ESG factors affect investments; it's also about how those investments impact the environment and society.

For instance, the chaotic transition out of brown industries as well as the intensifying impacts of physical climate risks, resource scarcity, and pollution may lead to increased costs for infrastructure projects. In addition to legal claims, emissions fines, these risks are no longer “Black Swan” events and represent real threats causing operational and supply chain disruptions, reputational damage, or even asset destruction. Additionally, governance risks such as corruption, regulatory compliance, and transparency issues can undermine project integrity and investor confidence. These examples underscore the direct impact of environmental and governance risks on the cash flows and asset value of infrastructure investments.

In the other direction, the direct impacts of infrastructure on the environment and society are significant and directly affect cash flows. Issues such as biodiversity preservation, pollution and social acceptance can lead to delays in permitting, operational restrictions, increased operational costs and further reputational risks.

Walking the talk requires thinking outside the box

Infrastructure managers who conduct thorough ESG risk analysis are certain to enhance their projects' resilience and safeguard long-term value. Their efforts also unlock opportunities for innovation, efficiency improvements, and stakeholder engagement. This can have the additional benefit of driving sustainable development outcomes for the communities where they invest and contributing to the achievement of broader sustainability goals.

But it's not all smooth sailing. Integrating ESG principles into infrastructure management comes with its own set of challenges. While regulations like the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy for sustainable activities are pushing us in the right direction, they also add complexity to the mix. Asset managers grapple with the challenge of taxonomy alignment, weighing the trade-offs between investing in newly constructed taxonomy aligned assets versus upgrading existing infrastructure to improve its sustainability performance (knowing it will not reach alignment with the Taxonomy). Marginal improvements may not meet stringent taxonomy criteria, yet they signify progress towards a more sustainable future.

Sustainable infrastructure and yet not taxonomy aligned

Consider the dilemma faced in financing sectors traditionally deemed environmentally unfriendly, such as data centers and transportation.

Let us illustrate this with an example from one of our recent investments.

I4B is a lead investor in a public-private partnership initiated by the Flemish region to upgrade a secondary road linking Ghent and the port of Ghent, into primary roads.
The social benefits of the project are unmistakable. By alleviating road congestion and curbing CO2 emissions, the project promises tangible improvements in urban mobility and air quality. Most notably, estimates suggest a remarkable 60% reduction in accidents involving pedestrians, cyclists, and other vulnerable road users upon project completion.

> Given the critical role of infrastructure in shaping communities and economies, integrating environmental, social, and governance risk analysis is paramount to creating long-term value and resilience.

On the environmental front, meticulous planning has been undertaken to ensure sustainability at every turn. With strict environmental permits secured, the project meticulously considers its impact on local ecosystems, waste management, water usage, and more. A hallmark of the initiative is the construction of over 22 kilometers of interconnected cycle highways, promoting eco-friendly commuting options and fostering active lifestyles.

The project also champions biodiversity preservation through the creation of eco-ducts, facilitating safe passage for local wildlife across the road. Measures to offset the impact of tree removal during construction—exceeding replanting efforts by 14.02 hectares—underscore a commitment to environmental stewardship.

In addition, innovative noise reduction strategies, including the installation of noise barriers and the utilization of "whisper asphalt," demonstrate a holistic approach to minimizing environmental disruption and enhancing community well-being.

> While the SFDR and Taxonomy serve as positive steps forward, it's crucial for managers to avoid getting lost in mere compliance. It's not just about ticking boxes; the focus should remain on genuine ESG risk analysis and financing the construction, renovation, and scaling up of infrastructure.

While for I4B the opportunity to provide financing for this infrastructure upgrade represents a sustainable investment with undeniable social and environmental benefits, it falls short of full taxonomy alignment as road infrastructure investments are not explicitly addressed in the EU Taxonomy Regulation, and only certain facets of the project align with the taxonomy's criteria for sustainable activities.

This example underscores the evolving restrictive nature of sustainable finance frameworks and the imperative for continued efforts to align the regulatory framework with the reality of infrastructure projects in need for sustainable renovation capital.

The Bottom line: committing to sustainable investment transcends regulation

Striking a balance between ESG considerations and societal needs necessitates pragmatism and innovation. Incremental changes pave the way for meaningful progress, ensuring that infrastructure investments align with sustainability objectives without sacrificing essential services.

While the SFDR and Taxonomy serve as positive steps forward, it's crucial for managers to avoid getting lost in mere compliance. It's not just about ticking boxes; the focus should remain on genuine ESG risk analysis and financing the construction, renovation, and scaling up of infrastructure—both new and old. Taking incremental steps is key. Even small changes can make a significant difference in advancing sustainability goals.

In essence, integrating ESG principles in infrastructure investments transcends regulatory compliance—it embodies a commitment to long-term value creation and resilience.

Private Debt Funds – How to Strike the Right Balance Between ESG Integration and Regulatory Requirements

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1.1 Private Debt as an Emerging Asset Class in the spotlight

Private debt has risen as a compelling alternative to traditional bank lending, marking its place as a relatively new asset class, especially when compared to established ones like private equity. The nature of private debt is inherently diverse, providing exposure to a wide range of assets.

Private debt has experienced a promising period in recent months. A Preqin survey indicates a bullish outlook from investors, especially for direct lending strategies for several reasons:

• **Growth Indicators:** General Partners (GPs) are targeting an impressive $487.3 billion in aggregate capital as of March 31, 2024.

• **Investor Satisfaction:** A resounding 90% of investors surveyed reported that private debt has met or exceeded their expectations. Furthermore, 91% anticipate that private debt will perform as well or better this year compared to the previous year.

• **Direct Lending Dominance:** Direct lending represents the majority of fundraising in the first quarter.

• **Investment Intentions:** In the first quarter of 2024, 70% of Limited Partners (LPs) planned to invest up to $50 million in private debt funds, an increase from 63% in the same quarter of 2023.

In this context, it should be noted that ESG considerations are paramount for investors in private debt funds.

A vast majority of investors consider ESG a top-three factors for successful private debt investment and believe ESG integration can enhance risk management and yield better long-term returns in private debt, infrastructure and real estate debt.

Despite the momentum, ESG integration faces significant challenges, including regulatory ambiguity in relation to certain concepts (such as transition) as well as data accessibility issues.

1.2 Private debt funds with a transition focus

The EU's sustainable finance policy is designed to attract private investment to support the transition to a sustainable, climate-neutral economy.

As part of the EU sustainable finance package, the Sustainable Finance Disclosures Regulation (SFDR) deals with the integration of sustainability risks (article 6 SFDR) and principal adverse impacts at fund level (article 7 SFDR) and manager level (article 4 SFDR), but it also introduces additional product disclosures for financial products making sustainability claims under its articles 8 and 9.

Currently, funds that support and finance the transition to a sustainable economy are making sustainability claims under Article 8 of the SFDR. This situation presents a paradox. Transition is a central concept in the EU's sustainable finance landscape, suggesting that these funds should be able to disclose under Article 9 of the SFDR. Such a move would enable them to distinguish themselves from

> Noticeable progress in getting reliable data has also been seen for funds using instruments such as sustainability linked leveraged loans and ESG margin ratchets when structuring the debt to underlying companies.

other funds that are also categorized under Article 8, thereby providing clearer information to investors and stakeholders about the nature and seriousness of their sustainability efforts and allowing a proper comparison between transition-driven products.

A significant majority of 72% of respondents to the European Commission consultation paper on the SFDR reform from December 2023 are in favor of establishing a distinct category (or even a label) for funds that concentrate on transition. This category would cover funds with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets they invest in, e.g. investments in economic activities becoming taxonomy-aligned or in transitional economic activities that are taxonomy aligned, investments in companies, economic activities or portfolios with credible targets and/or plans to decarbonize, improve workers' rights, reduce environmental impacts. Many respondents also argued that metrics on transition should be added.

It is unclear whether categories or labels will be adopted under the revised SFDR framework or the current disclosure regime will be kept but clarity should be introduced in terms of where transition strategies should sit.

Sustainable investment, as outlined in SFDR Article 2(17), should encompass not only those investments that are sustainable from the outset but also those that demonstrate a credible trajectory towards sustainability within a clearly defined timeframe. This timeframe should be established considering various factors such as the nature of the ESG (Environmental, Social, and Governance) topic, geographic location, and sector-specific characteristics. Moreover, for an investment to qualify under this definition, it must be backed by concrete actions, a business and development plan and an allocated budget. This approach broadens the scope to include both transition and impact investments, recognizing the potential for positive change and the importance of supporting investments that are on a path to sustainability. These funds would target measurable improvements in the sustainability profiles of assets and the concept of principal adverse impacts (PAIs) is key. As a result, the barrier between "taking into account PAIs" (ex ante assessment) and "consider PAIs" (ex post mitigation) should be redefined in order to ensure that transitional assets are properly captured when applying the "do not significantly harm" test under article 2(17) SFDR. It is crucial to adopt such or similar approaches to mitigate the risk of greenwashing.

1.3 Data access and reliability for private debt funds

Accessing reliable ESG data is a major hurdle, particularly for private debt managers who do not directly manage assets and must rely on communication with equity sponsors and underlying companies. Smaller companies within the private debt space may find comprehensive ESG reporting challenging.

However, several structuring options have been tested so far by private debt managers in order to be able to access good quality data. Some argue that single lenders or a consortium of several lenders with a lead lender may have an easier time obtaining information from these smaller entities.

An effective engagement framework between private dent funds as lenders and portfolio companies as borrowers should be privileged and should encompass strategies for escalation processes to set meaningful goals to the later.

The parties will generally introduce reporting fact sheets to streamline the disclosure process. Such fact sheet could be used as well to ensure that the milestone of the transitional strategy (if relevant for the private debt funds at stake) are met – as suggested in the previous section. Noticeable progress in getting reliable data has also been seen for funds using instruments such as sustainability linked leveraged loans and ESG margin ratchets when structuring the debt to underlying companies.

As for the collection of PAIs, it should be noted that certain prescribed PAIs are, in most cases, not always material or even relevant for the day-to-day operations of businesses in different sectors, geographies and jurisdictions. In the context of the revisions to SFDR and the entry into force of the Corporate Sustainability Reporting Directive (CSRD), a materiality assessment in respect of PAIs under SFDR, reflective of the same flexibility enshrined under the CSRD and the accompanying European Sustainability Reporting Standards (ESRS), could facilitate the collection of good quality data by private debt fund managers. In practice this would mean that instead of having a pre-defined set of mandatory PAI indicators which may not be material to the pursued investment strategy of the fund, managers should be in a position to define (based on a reasonable materiality assessment) which PAI indicators are material to the fund's strategy. PAIs and ESRS alignment would also mean that some of the indicators and datapoints that seek to measure the same subject matter would no longer exhibit unexplained methodological and definitional differences - as it is the case now - between different legislation.

Considering that the scope of CSRD is still limited, reporting terms would need to be defined contractually by private debt funds as lenders and the portfolio companies as borrowers – with the possibility to involve the equity holders too. A voluntary opt-in by borrowers under CSRD would be the preferred option but it will very much depend on the size of the financing deal and the negotiation power of the lender(s). In absence of such opt-in, the use of estimates and best efforts may still be relevant when borrowers are not in the scope of CSRD.

> "Accessing reliable ESG data is a major hurdle, particularly for private debt managers who do not directly manage assets and must rely on communication with equity sponsors and underlying companies.

Data reporting and data quality assessment in private debt should also be considered in light of a private debt fund lifecycle that includes periods like amortization and liquidation where the control over the portfolio companies diminishes making it challenging to meet the ESG ratios and key performance indicators. The binding elements of the private debt funds investment strategy should clearly indicate what standards and data are disapplied during these specific periods. This approach would clearly reduce the risks of greenwashing. At national level, as we will see in the next section, the various lifecycles of funds are taken into account with respect to ESG investment limits.

1.4 The impact of ESG Rating Regulation on private debt fund managers

The EU's recent agreement on a regulation concerning ESG rating activities marks a significant step in the regulation of ESG ratings in Europe, introducing the first compulsory rules for ESG rating providers and users in Europe. This regulation is set to impact a wide range of financial entities, including asset managers who use ESG ratings for their products and services carried out in or marketed into the EU, regardless of whether these ratings are provided by third parties or generated by the asset manager using its own proprietary methodology.

The regulation is particularly relevant for Luxembourg private debt funds that incorporate an ESG strategy, as well as their EU AIFMs.

AIFMs should determine whether they are considered ESG rating providers or users. This distinction is important because it dictates the regulatory requirements that the entity must adhere to. For example, an EU AIFM that employs its own proprietary methodology to generate ESG scores for the investments within a private debt fund would be classified as an ESG rating provider.

There are certain exemptions that may apply to these entities, potentially relieving them from some of the substantive obligations. These exemptions are contingent upon the use of the ESG ratings. If the ratings are used exclusively for private, internal, or intra-group purposes, or if they are disclosed solely as part of the entity's SFDR or Taxonomy Regulation disclosures, the AIFM may not be subject to the full breadth of the regulation.

However, if an AIFM discloses ESG ratings to third parties as part of its marketing communications for products and services regulated under EU law, it will be subject to additional disclosure obligations. These obligations include providing detailed information on its website about various aspects of the ESG rating process (such as information on the rating methodologies used, data sources and the limitations of these sources, scope and topics of the ESG ratings, consideration of international agreements, use of AI, fees and their payment model, ownership and potential conflicts of interest). Additionally, AIFMs must include a link to their website in the related-marketing communications.

The regulation is not yet in force, but it is expected to be adopted by the European Parliament and the Council in the coming month. Once in effect, the regulation will apply 18 months after its entry into force, with some transitional provisions for existing ESG rating providers.

1.5 ESMA guidelines on funds' names

The ESMA has recently refined its approach to the use of ESG and sustainability-related terms in fund names. This update aims at ensuring that the terminology used by funds accurately reflects their investment strategies and the expectations of investors.

To use ESG-, impact-, transition- or sustainability-related terms in their names, private debt funds must meet certain criteria, including a minimum investment threshold of 80% in assets that align with ESG characteristics or sustainable investment objectives. They must also adhere to specific exclusion criteria, depending on the term used either the Climate Transition Benchmark (CTB) or the Paris-aligned Benchmark (PAB) exclusions, which prohibit investment in certain controversial sectors. The guidelines impose qualitative criteria for the use of certain terms, ensuring that the fund's strategy is genuinely linked to its name.

In the first draft of the guidelines, funds needed to allocate at least 50% of their portfolio to sustainable investments to use sustainability-related terms in their name. ESMA will now require a minimum of 80% of the investments to align with sustainability characteristics or objectives. Additionally, funds must adhere to the Paris-aligned Benchmark (PAB) exclusions and invest meaningfully in sustainable investments.

This shift therefore allows not only article 9 but also article 8 funds to use sustainability-related terms while ensuring that a fund's name is an accurate representation of its investment focus.

ESMA has introduced a new category specifically for transition-related terms. If a private debt fund includes these terms in its name, it must not only meet the 80% threshold but also comply with Climate Transition Benchmark (CTB) exclusions. This nuanced approach recognizes the role of funds that support the transition to a greener economy and ensures they are not unfairly disadvantaged by the guidelines.

The distinction between environmental, social, and governance terms has been further clarified. ESMA acknowledges that combining social or governance terms with environmental ones could unduly limit a fund's investment universe. Therefore, when environmental terms are paired with "transition" terms, CTB exclusions will apply. However, the use of "sustainable" related terms in a fund's name implies a broad commitment to sustainability, regardless of other terms used.

If a fund incorporates "transition" or "impact" related terms in its names, it must ensure that the investments it makes are not only part of the 80% threshold but are also on a measurable path to environmental or social transition or intended to generate a positive social or environmental impact. This requirement emphasizes the importance of tangible outcomes in investment strategies and aligns with investor expectations for funds that claim to have an impact or support a transition.

The guidelines will take effect three months after their publication in all EU official languages on ESMA's website. Asset managers planning to launch a new private debt fund or have private debt funds using ESG-related terms in their names, will have to comply with these guidelines for new funds from the application date and for existing funds within six months thereafter.

The updated guidelines reflect a more rigorous and transparent approach to fund naming, ensuring that the terms used genuinely represent the fund's investment strategy.

1.6 New reporting for Luxembourg private debt funds: focus on ESG investment restriction breaches

The new CSSF's Circular 24/856 introduces a significant update to its regulatory framework on net asset valuation (NAV) errors and investment restrictions breaches. The circular expands the previous guidelines set forth in Circular 02/77, broadening the scope to encompass a wider range of alternative investment vehicles. The implications of this Circular are particularly pertinent for Luxembourg private debt funds, that are regulated (eg. Part II UCIs, SIFs or SICARs) or that qualify under specific European labels such as ELTIFs, EuSEFs, EuVECAs, or MMFs. It addresses all investment restriction breaches, whether legal or contractual, including those relating to ESG criteria. A breach to ESG investment restrictions may further lead to NAV errors, which if significant must be corrected.

Funds in scope of the new circular must implement robust policies for managing NAV errors and breaches of investment restrictions by 1 January 2025 and may need to include additional investor disclosures at their next prospectus update (notably for Part II UCIs, MMFs, ELTIFs or in case of new shares issuance, for SIFs and SICARs).

ESG investment restrictions breaches can be active, when resulting from a deliberate action or omission, or passive, when it occurs unintentionally due to external factors. Active breaches, such as purchasing a bond from a fossil fuel company against the private debt fund's exclusion policy, require immediate action and notification to the CSSF.

Passive breaches, such as the downgrade of a debt issuer in the fund's portfolio below the ESG standards set in the fund's policy, must be corrected within a reasonable timeframe without CSSF's notification.

Private debt funds in scope must implement pre-trade and post-trade controls to ensure compliance with all investment restrictions, including those relating to ESG criteria. These controls must be tailored to the unique fund's characteristics (such as the ESG eligibility criteria, exclusion list, minimum and maximum percentage of certain ESG asset classes) and risks of investment restrictions breach, and clearly described in the fund's policies.

Continuous compliance with the eligibility and concentration rules is required by the Circular, not only during the NAV calculation process but also in the interim periods for funds that do not calculate NAV daily. For instance, when a private debt fund sets eligibility criteria such as a minimum ESG score for debt issuer or exclude issuers involved in controversial activities, it must perform regular checks to ensure that issuers continuously comply with these requirements.

For diversification and other investment restrictions, compliance checks are usually aligned with NAV calculations but significant transactions between two NAV calculations may require additional controls to prevent breaches. Upon identification of a breach, immediate notification to the relevant parties (fund's management body, its asset manager, fund administration or, and depositary) is mandatory, with corrective actions outlined in the fund's policies.

The Circular imposes to establish clear policies for managing breaches as from the fund's inception, including impact calculation method.

Corrective actions include for instance selling non-eligible investments, investment in breach of the fund's policy or in excess of its investment restrictions. If the breach resulted in a damage for the private debt fund, the fund must be compensated in accordance with the Circular. Tolerance thresholds for NAV calculation errors do not apply here.

The fund or its asset manager must assess the impact of breaches on NAVs and address significant NAV errors that exceed established tolerance thresholds. The asset managers of certain type of funds can freely determine the tolerance thresholds, which must not surpass 5% of the NAV (ie for SIFs, SICARs, EuSEFs, EuVECAs, non-retail Part II UCIs and non-retail ELTIFs). These thresholds must be documented and disclosed to investors. Significant NAV errors require prompt reporting to the UCI administrator and depositary, recalculation, and correction, potentially including compensation for affected investors or the fund for paid undue benefits.

Finally, any errors or active breaches must be reported to the CSSF using a specific notification form. The Fund or its asset manager must have organizational arrangements in place to ensure timely notification to the CSSF, adherence to reporting deadlines (4 to 8 weeks), calculate compensations and the provision of a special audit report if required.

As the market for ESG investments continues to grow and evolve, private debt funds will play a critical role in shaping the future of sustainable finance. By striking the right balance between ESG integration and regulatory compliance, private debt funds can contribute to a more sustainable and resilient financial system.

ESG and Debt Funds - Contrasting Regulatory Developments in the US and EU

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It is often considered that the EU stance at ESG is regulatory-driven, while the US is pursuing a market-driven approach.

The EU has been steering investments towards sustainable and climate transition activities for several years through its various regulatory frameworks, which has kept fund initiators busy. In the US, after several years of predominantly private sector led ESG integration, the US regulator is now in the process of adopting final rules on ESG disclosures for funds and advisors, underlining the increasing importance of ESG in the US.

Before delving into market tendencies and practices, it is important to address the primary interest of market participants - the ability to use data and disclosures under multiple frameworks. Below, the main elements of the EU and US framework are contrasted.

In 2022 the SEC issued a proposal on two sets of ESG-related rules with considerable impact for funds and sponsors – one establishing a fund categorisation system based on ESG objectives and the other introducing ESG-related rules in existing fund naming conventions. The latter applied from December 2023, with a 24 or 30-month compliance deadline, depending on the volume of assets under management.

The SEC proposal distinguishes between three fund categories: "ESG-integrated" funds, which consider one or more ESG factors; "ESG-focused" funds with at least significant consideration for one or more ESG factors (including GHG emissions or a prominent 'no-consideration' statement); and funds that pursue "ESG Impact" strategies, i.e. funds that have a stated goal to achieve a specific impact that generates specific ESG-related benefits. In any of the above categories data sources and evaluation methodologies will have to be disclosed, as well as their performance against selected criteria to be evaluated, flanked by pre-contractual documentation, annual reports and marketing documents. Even though website disclosures equivalent to those foreseen in the context of SFDR (e.g. Principle Adverse Impact (PAI) statement or Article 10 SFDR) are not foreseen, the proposed regime is in principle fairly similar to the regulatory framework existing in the EU, notwithstanding any potential changes to come in the near future.

> The experience shows that US asset managers conquering the EU market are fairly open and interested in the existing regulatory framework around ESG.

After three years of the application of the SFDR disclosure regime, and given that practically speaking Article 8 and 9 disclosures have been functioning more as a labelling regime, the EU is considering whether to keep the existing regime or to conduct an overhaul towards a proper labelling regime. In the latter case, the question remains whether and to which extent labels will be built on existing disclosures and whether a mandatory disclosure will be put in place for all market participants, regardless of their ESG category. Recent trends have shown that alongside the initial "greenwashing" tendency some market players are "greenhushing", i.e. deliberately not adhering to a specific regulatory ESG category and consequently not publishing sustainability-related information, either due to the belief that this does not bring any additional value to their investors, or in order to avoid the impression that the undertaken efforts are not sufficient. The EU Commission has recognised the existence of these practices and the burden of overregulation and has expressed the intent to simplify existing regulations and facilitate compliance, especially when it comes to transition finance and SME ESG reporting.

The issue raised by some US-based market participants is the absence of any underlying taxonomy which would categorise the fund's underlying investments and activities. However, as we can see from the experience in the EU regarding Taxonomy Regulation and the current reporting standards for companies under CSRD, the existence of such taxonomy will not necessarily render disclosures easier. Research showed that this was, in particular, the case with SFDR entity-level PAI disclosures, where it was found that less than one third of management companies were respecting the comply-or-explain principle, and the majority of published statements was incomplete.

Regarding fund names, the EU watchdog ESMA has abandoned its envisaged double threshold for sustainability-related terms in funds names. From the initially foreseen threshold of 50% of sustainable investments and within this limit an additional 80% threshold of environmental and social investments, it now lowered the requirements to a general minimum threshold of 80% of investments meeting sustainability criteria, alongside the application of Paris-aligned Benchmark exclusions and substantial allocation to sustainable investments within the meaning of the SFDR.

> The EU needs to show a clear and unambiguous path forward limiting overhauling of existing rules and overregulation in general, in order to remain attractive for US managers.

The same rules will apply to transition-, social- and governance-, and, as a separate group, environmental- and impact-related strategies. Transition- and impact-related strategies will have to be underpinned by a measurable path (towards transition), or impact. The SEC naming convention can be considered as aligned to these standards as it will impose a general 80% asset allocation threshold towards the type of investment featured in the name of the fund. This is intended to cover the fund's investment focus, but aims mainly at capturing terms that imply consideration of ESG factors.

Challenges for US investors

The experience shows that US asset managers conquering the EU market are fairly open and interested in the existing regulatory framework around ESG. Over the years the EU ESG regulations have evolved and many US manager have closely followed this evolution and become familiar with the rules. Where initially queries on, for example, the scope of website disclosures, differentiation between entity- and manager-level disclosures, or applicability of PAI disclosures had to be addressed, discussions are now much more related to the actual implementation of thorough and ambitious ESG strategies in the day-to-day portfolio management in line with regulations.

This being said, a pragmatic and streamlined approach is often welcomed by US managers, in particular for sophisticated debt fund structures where levered and unlevered sleeves are being implemented, with parallel master-feeder structures including fund vehicles in different EU jurisdictions, most often Luxembourg and Ireland.

It is therefore key to ensure a harmonized and integrated approach, with e.g. SFDR disclosures under Annex II responding to both, the regulatory expectations from the CBI and the CSSF in order to avoid a multitude of slightly differing sets of disclosures.

Another challenge currently arising for US managers is the surge of an anti-ESG movement in the US resulting in fragmented policy environment at federal and state levels. Some US institutional investors for instance therefore cannot invest in any fund product that imposes ESG related criteria, whereas in the same fund structure other investors will want to see a certain minimum commitment to ESG factors.

The same fund structure may then have to integrate differing ESG appetite for different groups of investors. This dilemma can result in complex structures with separate fund sleeves and portfolios managed by separate portfolio managers, each responsible for investments depending on whether ESG factors are being taken into consideration or not. In parallel fund structures the provisions governing the functioning between the different sleeves, such as re-balancing clauses, need to be carefully looked at in order to avoid any regulatory or investor policy breach.

In both, the EU and the US the future integration of ESG factors into the regulatory landscape depends on various factors, and not the least political decisions, which set the overall direction. The EU needs to show a clear and unambiguous path forward limiting overhauling of existing rules and overregulation in general, in order to remain attractive for US managers. On the other side, the US is becoming more and more fragmented with regard to ESG appetite and it is to be hoped that the SEC rules are giving rise to a new ESG perception.

At Ogier Luxembourg we are working with US asset managers on a daily basis and are very much accustomed to the issues that arise for US managers when reconciling the expectations from investors around the globe and ensuring compliance with different sets of regulations. Our experts in our Luxembourg and Ireland offices are available to assist you with any project or questions you may have in this field.