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The Evolution of Sustainability Provisions in the Private Debt Market

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Introduction

Despite initially lagging behind other asset classes the European leveraged finance sector has seen an exponential increase in the integration of environmental, social and governance (**ESG**) factors in loan products since 2020.

Issuance of leveraged loans containing an ESG-linked margin ratchet reached 75% of total issuance in Q4 2022, slowing slightly recently in line with primary market activity, measuring 50% of total issuance for the last six months to date.[1]

ESG integration in private debt deals is comparatively nascent although, due to increased regulatory and investor demand, it is now a top priority for the private debt sector. Whilst comprehensive ESG data for the private debt sector is less readily available than for other sectors, according to Debtwire, as of the first nine months of 2022 "ESG-linked private debt" accounted for 25.4 per cent of all private debt market transactions in Europe.[2]

ELFA has charted the evolution of this trend in the private debt sector in a series of reports published during 2021 and 2022 and most recently added a new chapter "ESG in the Private Debt Markets" to the second edition of the Guide for Company Advisors to ESG Disclosure in Leveraged Finance Transactions.[3]

ESG integration in private debt deals brings ample opportunities however challenges remain for the leveraged finance sector generally and direct lenders face additional challenges which are specific to the nature of private debt borrowers and, to some extent, this asset class.[4]

In this report, we will:

- examine the development of ESG Loans and in particular sustainability-linked loans in the European leveraged loans market and compare the approaches of large-cap syndicated leveraged deals to private debt deals;
- analyse the challenges faced by direct lenders in providing sustainability-linked loans and consider alternative ESG loan structures;
- consider the key characteristics of sustainability-linked loans and the development of key contractual terms;
- consider how direct lenders can mitigate the risk of sustainability washing in alternative loan structures; and
- summarise key developments in the European market going forward.

[1] Source: Covenant Review, a FitchSolutions Company. For a review of ESG-related data in European leveraged loans in 2022, see https://members.elfainvestors.com/resource/esg-trend-lines-2022-year-in-review

[2] This is comparable to last year's data. See ESG ratchets become the new normal but mechanism suffers teething issues - Mid Market Chatter at https://www.debtwire.com/intelligence/view/intelcms-sw27hs

[3] https://elfainvestors.com/publications/elfa-insights/?date=March+2022, https://elfainvestors.com/publications/elfa-insights/?date=October+2021 and https://elfainvestors.com/publications/elfa-diligence/

[4] Some of the information in this article is drawn from discussions with various market participants from across the industry.

A note of caution!

Some confusion exists in the market around the labelling of similar products. Sustainability-linked loans, ESG-linked loans, KPI-loans, general purpose loans and ESG loans are some of the terms which are often used interchangeably and without specific distinction regarding the ESG features included in the relevant loan product.

For the purposes of this report, the terms set out below will have the following meanings:

- **Sustainability-linked Loans or SLLs** refer to loans which adhere to the sustainability-linked loan principles and related guidance published by the Asia Pacific Loan Market Association (**APLMA**), the Loan Market Association (**LMA**) and the Loan Syndications and Trading Association (**LSTA**) published by the LMA along with related guidance in March 2019 with updated versions published in 2021 and 2022 (the "**SLLP**")[5,6]
- **ESG-linked Loans** refer to loans which include some ESG features (usually with a loan margin that steps up or down if certain ESG KPIs are met) but do not otherwise adhere to the SLLP fully; and
- **ESG Loans** is used as an overarching term which refers to loans which incorporate ESG factors including SLLs, green loans and social loans.[7]

ESG Loan Products

Labelled loan products

There are three main categories of ESG "labelled" loan issuance: green loans, social loans and SLLs.

Green loans and social loans are both "use of proceeds" products and must be applied for specific green projects or social projects.[8] The proceeds of SLLs, on the other hand, can be applied for general corporate purposes allowing borrowers to also access a wider range of key performance indicators to signal sustainability credibility to external stakeholders.

This inherent flexibility is a primary factor in increasing SLL issuance which now exceeds green loan issuance in Europe.[9] This is particularly important for the private debt sector which typically lends to mid-market borrowers (many of whom may not have an obvious environmental or social agenda and/or may be at the start of their sustainability journey).

The use of green and social loans in leveraged finance deals (including private debt deals) is relatively uncommon compared to other sectors. However, these loan products (and indeed a combination of labelled loan products and structures) may be helpful to the private debt sector as direct lenders grapple with the need to align multiple demands for ESG integration.

For example, under regulation (such as the Sustainable Finance Disclosure Regulation (**SFDR**) and EU Taxonomy Regulation), industry standards (such as the Principles for Responsible Investment (**PRI**)) and investor demands - all of which will require careful consideration of the loan structures, contractual terms and on-going reporting and monitoring.[10]

SLLs, ESG-linked Loans and Sleeping SLLs

The SLLP provide the market with recommended guidelines for the fundamental characteristics of SLLs whilst also maintaining flexibility for the development of the product by the market. In order to be classified, marketed or referred to as an SLL, a loan must be aligned with the following five core components:

- selection of key performance indicators (**KPIs**);
- calibration of specific performance targets (**SPTs**);
- loan characteristics;
- reporting; and
- verification.

The SLLP set out detailed criteria, information and best practice for adhering to the five core components with the aim of preserving the integrity and credibility of SLLs and addressing the risk of sustainability washing.[11] This describes situations where claims on sustainable credentials are misleading, inaccurate or inflated.

Market practice regarding SLL issuance and integration of ESG factors in loans varies across the leveraged finance market including within large-cap and mid-cap syndicated leveraged deals and private debt deals. For the purposes of this report, we will examine the challenges which have emerged in the private debt sector, how they are interrelated and how the private debt market has responded.

- **Sourcing ESG-related data and sustainability policies:** Mid-market borrowers, unlike larger corporates, are more likely to lack historical ESG data. Their efforts in this regard may be hampered by a lack of resources, skills, systems and processes to collate and analyse relevant ESG data and the wider ESG eco-system. Obtaining publicly available information for these companies is still a challenge.

  This is markedly different to the large-cap syndicated market where borrowers are typically larger entities, often have an existing and/or good ESG profile and, more often than not, are already obliged to analyse and disclose their ESG credentials to a range of external stakeholders.

[5] LMA Sustainability-linked loan principles 2022, Available from: https://www.lma.eu.com/application/files/9216/4873/5603/Sustainability-Linked_Loan_Principles_31_March_2022.pdf; and LMA Sustainability-linked loan guidance 2022, Available from: https://www.lma.eu.com/application/files/9416/4873/5604/Sustainability-Linked_Loan_Principles_Guidance_31_March_2022.pdf

[6] The LMA is in the process of updating the SLLP with revised versions expected to be published in 2023. Following publication of the revised SLLP by the LMA, ELFA intends to publish an update to this report.

[7] LMA Sustainable Lending Glossary 2021, Available from: https://www.lma.eu.com/application/files/1416/3092/3134/LMA_Sustainable_Lending_Glossary_V111.pdf

[8] LMA Green Loan Principles 2021, Available from: https://www.lma.eu.com/application/files/9716/1304/3740/Green_Loan_Principles_Feb2021_V04.pdf; LMA Green Loan Guidance 2021, Available from: https://www.lma.eu.com/application/files/2416/1303/5144/GLP_Guidance_Feb2021_V02.pdf; LMA Social Loan Principles 2021, Available from: https://www.lma.eu.com/application/files/1816/1829/9975/Social_Loan_Principles.pdf; LMA Social Loan Guidance 2022, Available from: https://www.lma.eu.com/application/files/2016/4623/8946/SLP_Guidance.pdf

[9] According to AFME's ESG Finance Report – European Sustainable Finance, in H1 2022, sustainability-linked Loans represented 75.8% of the total ESG-linked Loan market, compared to 24.2% of green-linked loans. However, during Q3 2022, Sustainability-linked and Green-linked loan issuance represented 25% of total European syndicated loan origination, down from 26% in FY 2021 due to a quieter market backdrop.

[10] Additional useful resources are available from: Pre-Issuance-checklist-Green-Bonds_June-2022-280622.pdf (icmagroup.org); and Pre-issuance-Checklist-for-Social-Bonds-and-Social-Bond-Programmes-June-2021-100621.pdf (icmagroup.org)

[11] For the purposes of this report, we will refer to the term "sustainability washing" rather than green washing (which is used to refer to misleading environmental credentials). SLLs are intended to be used across a broad range of ESG-related KPIs therefore this wider term is more appropriate in this context.

It is worth elaborating specifically on sustainability policies and strategies. Whilst the LMA have made it clear that the lack of a robust sustainability strategy must not be a barrier to undertaking an SLL, borrowers are required to explain the rationale for the selection of KPIs and SPTs within the context of any sustainability policies and strategies.[12] This can provide lenders with useful information regarding the borrower's sustainability goals and explain the rationale for the selection of KPIs and SPTs. As a result, many banks are now requesting that borrowers have a sustainability strategy/policy in order to access SLLs and go as far as embedding this requirement within SLL frameworks.

In the private debt market, there remains a variation of approaches – some lenders require borrowers to have a sustainability policy/strategy, others require minimum ESG-related information (e.g., suggested KPIs or specific ESG information (such as GHG emissions)) and many direct lenders do not have any minimum ESG-related standards.

What is clear is that early, direct and proactive engagement with private equity sponsors and borrowers has become an essential and unavoidable part of the process of structuring SLLs and ESG-linked Loans, and sustainability readiness must be considered prior to any transaction timeline being put in place.

- **Timing pressure:** The SLLP make clear that sustainability objectives need to be predefined and SPTs and KPIs predetermined (i.e., agreed at the time of origination). Whilst discussions continue as to exactly what this means in the context of different deal timetables, what is clear is that these need to be included in the loan agreement in order for the loan to be classified as an SLL. This means that determining the nature of the ESG information available (including the existence of a sustainability strategy/policy) is one of the first questions that must be asked in the context of a potential SLL structure.

  In large-cap syndicated deals and club deals, potential lenders also need to be allowed sufficient time to consider and analyse ESG-related information from the borrower in light of different internal SLL frameworks, methodologies, mandatory requirements and minimum standards.

- **Cost implications:** Sustainability has cost implications both pre-signing and post signing. The LMA recommends that borrowers seek input from an external party (in the form of a second party opinion (**SPO**) or involvement of an ESG consultant) as to the appropriateness of the KPIs and SPTs in an SLL at signing. This is not however a mandatory requirement at this stage and in the absence of this, the borrower needs to demonstrate or develop the internal expertise to verify its methodologies.

  Whilst these remain recommendations under the SLLP, in large-cap syndicated deals, borrowers are often either able to satisfy one or both of these requirements. In the private debt market, the absence of relevant reliable ESG data has resulted in increased pressure for SPOs and/or the involvement of ESG consultants and this together with the need for mandatory annual verification (see below) results in increased costs.[13]

  Structuring an SLL or ESG-linked Loan in this way alongside compressed deal timelines (particularly in the context of acquisition finance deals and/or where an auction process is being run)[14] can therefore be complex and involve significant costs (which, for mid-market borrowers, can prove to be prohibitive). As a result, across the leveraged finance market, alternative structures to SLLs have emerged (for the avoidance of doubt, a loan product shouldn't be classified as a SLL unless it adheres to the SLLP on the date of signing):

- **Post-signing ESG analysis / Agree to agree ESG terms:** 2020 saw a number of loans labelled as SLLs or "ESG-linked" where the loans contained only an agreement to agree ESG related terms post-signing. This drew strong criticism from the market and adverse media scrutiny amid accusations of sustainability washing. The increased experience and knowledge of both market participants and their advisors has decreased the use of this approach with lenders preferring not to label or refer to these types of loans as SLLs or ESG-linked.

- **Sleeping SLLs:** In the event that timing issues prevent the structuring of an SLL (or indeed an ESG-linked Loan (see below)) but some relevant ESG information is made available, market participants may opt for a sleeping SLL structure.[15] These are loans which "switch" on the SLL label after signing once full diligence of the proposed KPIs and SPTs is completed and provided that the loan adheres to the SLLP and related guidance at the time it is activated.[16]

  With a view to minimising any risk of sustainability washing, some market participants (including direct lenders) have taken the view of restricting or prohibiting sleeping SLLs, choosing instead to rely on the usual amendment provisions in the facility agreement. In the private debt sector, market participants indicate that sleeping SLLs are usually activated within 6-12 months of signing with a few cases being activated within 3 months. This short activation period is in keeping with the goals of the SLLP to allow the borrower to demonstrate an improvement to their sustainability profile throughout the term of the loan.

- **ESG-linked Loans:** ESG-linked Loans are the most frequently used alternative structure to SLLs across the leveraged finance sector but are not supported by any specifically created industry framework; ELFA has previously published Insights reports exploring these agreements and the related issues.[17]

[12] LMA: "It's a Matter of Time", 2022. Available from: https://www.lma.eu.com/application/files/8816/5719/9020/2022_ESG_Article_Matter_of_Timing.pdf

[13] In order for the economics of the deal to work, if an ESG consultant is used to compile information and reports on signing, a second party opinion is not required in addition to this.

[14] See LMA-ELFA Best Practice Guide to Sustainability Linked Leveraged Loans: https://elfainvestors.com/publication/2668/

[15] These are also sometimes referred to conversion SLLs or SLL flicks.

[16] Further guidance on "sleeping SLLs" is set out in the LMA note "It's a Matter of Time". [ibid, 11]

[17] ELFA has published two Insights reports on these evolving terms: https://elfainvestors.com/wp-content/uploads/2021/04/ELFA-Insights-Are-ESG-margin-ratchets-saving-the-planet-or-saving-borrowers-money.pdf and https://elfainvestors.com/wp-content/uploads/2021/07/ELFA-Insights-17-The-Emergence-of-ESG-Provisions-in-Leveraged-Finance-Transactions.pdf

As a result, there is a wide variation in the ESG contractual terms and level of detail included within loan agreements, with market participant determining a bespoke structure and contractual terms for each loan. In order to mitigate the risk of sustainability washing, the SLLP can and should be used as guidance for these loan structures; however, at present, the application of the SLLP across the leveraged finance sector (including within large cap syndicated deals and private debt deals) is inconsistent.

Indeed, regulators are focused on this topic with relevant proposals currently in progress from the Financial Conduct Authority and the European Securities and Markets Authority.[18]

The approach to SLLs, ESG-linked Loans and sleeping SLLs varies across the private debt market with funds taking the following approaches:

(a) structuring loans as SLLs only (taking care to ensure alignment with the SLLP) and, if this is not possible, refusing the investment opportunity or structuring as a standard loan without including any ESG contractual terms;

(b) structuring as ESG-linked Loans (often based on an internally created framework for ESG-linked Loans) including at least a margin ratchet linked to KPIs and SPTs; and

(c) a combination of both of the above and sleeping SLLs.

ESG Contractual Terms

As indicated above, across both the large-cap and mid-cap syndicated leveraged market and private debt market there is wide variation in the ESG terms and level of detail included in SLL agreements. Some loan agreements will set out the full information required by the SLLP (even where this information is included in SLL related reports and information delivered as conditions precedent) whilst others will take the approach of cross-referring to these external documents and reports for relevant required details. This variation of approach is more marked in the context of ESG-linked Loans.

Disclosures and publicity about "ESG-linked Loans" often lack the details of ESG features incorporated in loan agreements making standardisation of approaches to ESG contractual terms difficult.

The LMA and LSTA intend to provide some harmonisation of approach by publishing model terms for sustainability linked loans in facility agreements **Model SLL Terms**) in 2023 with the APLMA publishing a Model SLL terms for inclusion in term sheets. These model terms will provide additional guidance to market participants as to the level of detail which should be included in loan agreements. ELFA intends to publish an update to this report when the model terms are published.

Key Performance Indicators and Sustainability Performance Targets

The selection of predetermined SPTs measured in accordance with predetermined KPIs in line with the criteria set out in the SLLP is key to ensuring the integrity of SLLs and ESG-linked Loans and avoiding risks and/or attracting accusations of sustainability washing.[19]

KPIs and SPTs must be relevant, material and core to a borrower's business strategy, measurable or otherwise quantifiable and capable of being externally benchmarked whilst also addressing the ESG challenges of the relevant industry sector. SPTs should remain relevant throughout the term of the loan, be ambitious and go beyond a "business as usual" trajectory.

The SLLP and related LMA resources[20] provide additional guidance of how to ensure that KPIs meet the above criteria as well as the level of detail which should be included in loan agreements (such as definitions of KPIs, baseline, calculation methodologies and details of any relevant benchmarks).

The following are key themes for consideration in the context of selecting KPIs and setting SPTs:

Materiality of KPIs: Assessing the materiality of KPIs is core to ensuring the credibility of SLLs (and indeed ESG-linked Loans) and this remains the subject of much discussion and debate. Materiality assessment may be easier for larger borrowers (who have undertaken materiality analyses or publicly report or disclose on ESG factors) and more work may be required for private debt deals. The wider ESG eco-system is working towards alignment of resources and approaches with references to materiality maps such as SASB[21] for example and additional resources such as the ICMA's Illustrative KPIs Registry becoming available.[22]

Standards and Benchmarks: The LMA and other industry bodies point to the use of standards, certifications and external benchmarks as important tools to ensure the credibility of the SLL product, determine the materiality of KPIs and ambition of SPTs and address the risks of sustainability washing. Additional guidance is now provided by both the LMA and ICMA[23] and the harmonisation of standards is being undertaken. Going forward, there is likely to be greater emphasis on the use of standards and external benchmarks as a way of ensuring the integrity of ESG Loans. In turn this will require market participants and their advisers alike to have greater familiarity with relevant standards, certifications and benchmarks so that they can be referenced where appropriate and relevant.[24]

[18] For more information, see https://www.fca.org.uk/publication/consultation/cp22-20.pdf and https://www.esma.europa.eu/sites/default/files/library/esma34-472-373_guidelines_on_funds_names.pdf

[19] "KPI Selection – A matter of materiality", 2022. Available from: https://www.lma.eu.com/application/files/7616/5709/9273/2022_ESG_Article_KPI_Selection__A_Matter_of_Materiality.pdf; See also: https://view.officeapps.live.com/op/view.aspx?src=https%3A%2F%2Fwww.icmagroup.org%2Fassets%2Fdocuments%2FSustainable-finance%2F2022-updates%2FRegistry-SLB-KPIs_Final_2022-06-24-280622.xlsx&wdOrigin=BROWSELINK; and SLB-QA-CLEAN-and-FINAL-for-publication-2022-06-24v2-050822.pdf (icmagroup.org)

[20] KPI Selection: A matter of materiality, It's a Matter of Time, Fear of Failure – Frustrating Ambition.

[21] https://www.sasb.org/standards/materiality-map/. Please note that the International Sustainability Standards Board (ISSB) is developing sustainability-related disclosure standards that will build on existing reporting initiatives such as SASB.

[22] The LMA is not intending to create a separate KPI registry for SLLs and will refer to the ICMA resources.

[23] See 4.2.2 of ICMA's Sustainability-Linked Bond Principles – See Related Questions. CTF-Handbook-QA-09122020.pdf (icmagroup.org)

[24] Climate Transition Finance list of tools, 2022. Available from: CTF-Methodologies-Registry_FINAL_2022-06-23-290622.xlsx (live.com)

Range of ESG KPIs: The market is moving away from the use of ESG ratings as a KPI and ESG ratings are unlikely to be included in the Model SLL Terms to be published by the LMA. Whilst historically, environmental KPIs have been most commonly used, a more diverse range of KPIs are now present (reflecting Appendix 1 of the SLLP) with significant interest in social KPIs over the course of the last 6 months. 2XGlobal provide a range of resources from the wider gender lens investing community including due diligence questionnaires, case studies, principles and contractual terms.

Number of KPIs: There are no set number of KPIs required under an SLL or an ESG-linked Loan however large-cap syndicated deal will often contain a basket of KPIs (usually between 3 and 5 KPIs). Direct lenders also often take the same approach but may also select a single KPI which is considered to be material in the context of the relevant borrower and industry.

SPTs: Whilst it is difficult to assess the level of ambition of SPTs, market participants are focussed on setting SPTs at the right level in order to incentivise behaviour and to have a positive impact. As a result, across the leveraged finance market, there is greater focus on year-on-year improvement supported by provisions which will amend SPTs in the event of non-achievement or if flat-lining.

Loan Characteristics

A key feature of SLLs is a margin ratchet linked to the achievement or non-achievement of the SPTs and usually applied to term loans although large-cap syndicated deals also see the margin ratchet applied to revolving credit facilities. In the syndicated loan market, a two-way margin ratchet is frequently included however many direct lenders prefer to include a one-way margin discount only to incentivise achievement of the SPTs.

In all deals, the application of the margin ratchet depends on the number and nature of KPIs (noting that an increase and decrease is not always linked to the same number of SPTs). In some syndicated leveraged deals, more complex blended margin ratchet provisions have been included. However, these blended ratchets are not common in the European leveraged finance market.

Operation of the margin ratchet may be subject to no event of default having occurred or continuing and delivery of an SLL compliance certificate along with annual ESG reporting and it is increasingly common for additional conditions affecting the margin ratchet to be included in loan terms.

It is worth noting that the application of margin discount or premium to agreed ESG projects, charities and/or NGOs is now under review. Whilst these were not often included in private debt deals, they were used (albeit inconsistently) in some mid-market syndicated deals. However, issues relating to defining the relevant projects, holding premia and discounts and application of proceeds have led to administrative issues and these are no longer being included in SLL frameworks.

The margin ratchet remains the main incentivisation mechanic for SLLs and whilst discussions around an SLL event of default continue generally, the inclusion of such a provision has not gained favour. In fact, SLL provisions are often specifically carved out of relevant event of default provisions.

One area in which syndicated loans and private debt deals diverge is the inclusion of definitions and provisions relating to material sustainability events, declassification provisions and rendez-vous clauses. Whilst many banks are including a form of these terms in their internal SLL frameworks, their use in the leveraged finance market remains inconsistent and whilst they are used in some private debt deals, they are relatively uncommon. It is worth noting however that these provisions together with amendments to the publicity clause are likely to remain important in the syndicated loan market in the context of loans classified as SLLs.

Reporting and Verification

The SLLP outline the ESG-related information required on signing (as conditions precedent) and on an annual basis for the purposes of monitoring achievement of SPTs.[26] Whilst some syndicated leveraged deals as well as private debt deals include a "No misleading information" representation, this approach is by no means standard across the market.

Annual verification and reporting for the purposes of monitoring the achievement of SPTs and to ensure that KPIs and SPTs continue to adhere to the SLLP is now mandatory under the SLLP. This is most commonly undertaken in the form of an SLL compliance certificate accompanied by a report provided by an external verifier. In sponsor-backed deals structured as ESG-linked Loans, sponsors may suggest that management reporting is the most appropriate way to measure ESG performance against KPIs.

All lenders are now looking more closely at the reporting terms and information they can secure in loan agreements. This information is required not only for the labelling of loans but also to address the risk of sustainability washing and for reporting and disclosure under relevant regulations (such as SFDR and EU Taxonomy Regulation) and industry standards (such as PRI).

The challenge in facility agreements is (i) balancing the need for relevant ESG related information with the ability and resources of the borrower (ii) considering the need to be notified of ESG controversies and (iii) aligning with any other ESG related data requirements (from investors and sponsor for example). Currently the market is using a variety of approaches to address these challenges, and ELFA is planning to facilitate engagement on these topics during a series of roundtable events to be announced shortly.

Amendments and rendez-vous clauses: Whilst the market continues to discuss the inclusion of rendez-vous clauses, there is no standard approach to the inclusion of these clauses versus relying on the standard amendment clause. Another issue raised frequently is the question of lender consent for "material" SLL

[25] GenderSmart Climate Finance Toolkit (Intersection of E&S). Available from: https://www.2xcollaborative.org/toolkit; BII Gender Toolkit, Available from: https://protect-eu.mimecast.com/s/o_xTCBBGGSnwMn6S6GPTU?domain=gendertoolkit.bii.co.uk/; 2X Criteria, Reference Guide and, IRIS+ Guide: https://www.2xchallenge.org/criteria; GenderSmart JEDI Tookit: https://jediinvesting.com/; GenderSmart Resource Library: https://protect-eu.mimecast.com/s/cP2CCKrllU1XB1Esohmsd?domain=gendersmartinvesting.com; See also: https://protect-eu.mimecast.com/s/vltTCG6NNH8D08YskkrRD?domain=static1.squarespace.com and https://protect-eu.mimecast.com/s/zOeXCJ6kkHn61nrSOgjkL?domain=static1.squarespace.com

[26] Guidelines for Green, Social, Sustainability and Sustainability Linked Bonds External Review, 2022. Available from: https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/External-Review-Guidelines_June-2022-280622.pdf

provisions. At the moment, no standard has been established for required consent levels for changes to SLL terms however some themes are emerging, for example, the need for all lender consent to activate sleeping SLLs and any definitions and provisions which relate to pricing. It is likely that what is to be included as a "material SLL provision" will continue to evolve with differences between large-cap deals and private debt deals.

Reducing the risk of sustainability washing

The wide variation of market practice for SLLs and ESG-linked loans and the lack of frameworks or standardised approach means that lenders must take care to reduce the risk of sustainability washing. In the context of SLLs and ESG-linked loans, a few approaches can be considered:

- regardless of whether the loan is structured as an SLL, the market now has certain expectations of ESG-linked Loans. Any communication (including to investors) in respect of ESG terms should be accurate and not misleading and where possible ensure consistency with internal SLL/ESG-linked Loan frameworks and policies (see below);
- classify a loan as an SLL only if it adheres to the SLLP and, to the extent possible and relevant, apply the SLLP criteria, guidelines and processes to any relevant ESG contractual terms included in ESG-linked Loans (particularly in respect of the selection of KPIs and SPTs);
- where possible, use external verification, assurance and second party opinion providers;
- where possible, use external benchmarks and references and where feasible use relevant standards to analyse the materiality of KPIs and the ambition of SPTs;[27]
- ensure that reporting and disclosure in loan agreements is aligned with regulatory disclosure and reporting requirements, transparency reports provided for industry or sector bodies and ESG data gathering and analysis across the investment cycle (including on-going monitoring of loan portfolios);
- ensure that all communication, disclosure and/or publicity of the loan (including to investors and other internal and external stakeholders) is consistent in referring to the ESG related contractual terms and be transparent as to the ESG elements of the loan (including any lack of adherence to the SLLPs);
- formalise the above and ensure an efficient process for internal updates, consistency of information and ESG reporting and disclosure by aligning product level SFDR and Taxonomy disclosure and reporting with SLLP, internal minimum and mandatory requirements, industry standards and investor demands. This has now become a critical step to manage risk and ensure efficiency of process for all market participants.

What is next?

The market for SLLs and ESG-linked loans remains in a state of rapid development as private debt funds grapple with sustainability related disclosures (including Article 8 and 9 of SFDR) and taxonomy regulations as well as investor demand for ESG-labelled products. Despite the challenge and the need for deeper ESG integration and additional reporting and disclosure, we will see important and positive developments in the private debt market going forward, including:

- the development of more efficient processes/systems to collect the granular ESG information/data required for sustainability related disclosures and taxonomy analysis (including at the product level) resulting in alignment of ESG integration across the investment life-cycle and in the context of loan documentation and portfolio monitoring;
- increased emphasis on robust SLL/ESG-linked frameworks which will become an important tool to ensure consistency of approach to ESG integration, creation of ESG scores, use of benchmarks and the consistent use of ESG contractual terms in SLLs and ESG-linked Loans;
- more disclosures under Article 8 of SFDR and the formation of impact funds to facilitate disclosures under Article 9;
- the creation of internal industry specific benchmarks, ESG scores and net impact scores; and
- greater collaboration and engagement with sponsors and borrowers and across industry bodies in order to standardise approaches to SLLs and ESG-linked Loans.

ELFA's work to support the growth of ESG in the private debt market

As discussed, sustainability provisions within the European private debt market have evolved significantly and present unique opportunities and challenges. We believe that greater coordination will drive efficiency. As such, we are planning to facilitate engagement on the topics discussed in this Insights report during a series of roundtable events to be announced shortly.

Over the last few years, we have contributed significantly to synchronise efforts in the leveraged finance market with a wide range of ESG resources available on our website. Some of these include:

- ELFA ESG Fact Sheets: The ESG Fact Sheets are designed to support borrowers when preparing ESG disclosure, and to facilitate engagement between investors and the companies to which they lend on important ESG factors. We plan to continuously update the ESG Fact Sheets series by incorporating additional sectors and adding data that could be relevant to an investment decision.

[27] Examples include the Global Reporting Initiative, SASB, International Integrated Reporting Framework, AccountAbility's Materiality Review. The International Sustainability Standards Board is also developing a comprehensive global baseline of sustainability-related disclosure standards to support market participants to make informed decisions about a company's sustainability-related risks and opportunities.

- Guide for Company Advisors to ESG Disclosure in Leveraged Finance Transactions, Second Edition: ELFA and the LMA co-hosted a workshop in January 2022 bringing together leveraged finance borrowers, banks, law firms, private equity sponsors and senior fund managers, among others, to exchange knowledge, discuss challenges and identify solutions to meet the market's growing need for more comprehensive ESG disclosure. Insights and key takeaways from this workshop have been incorporated into the Guide's second edition that also contains two new chapters on private debt and ESG litigation risk.
- Video Glossary on Key ESG Topics for borrowers of private debt: ELFA has created 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.

If you'd like to learn more about our initiatives or take part in our upcoming roundtable events, please send an email at events@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. 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 ELFA's website: www.elfainvestors.com.

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