PRACTICE NOTE

THOMSON REUTERS
PRACTICAL LAW™

What's Market: 2024 Mid-Year Trends in Large Cap and Middle Market Loans

by Practical Law Finance

Status: **Law stated as of 31 Jul 2024** | Jurisdiction: **United States**

This document is published by Practical Law and can be found at: **content.next.westlaw.com/w-043-4421**
Request a free trial and demonstration at: **tr.com/practicallaw-home**

An Expert's View: Elizabeth Yazgi, Loan Syndications & Trading Association (LSTA)

Elizabeth discusses ESG in the private credit space and outlines some of the primary challenges facing the market.

Sustainability and environmental, social, and governance (ESG) issues remain hot topics in the leveraged loan market. What are your thoughts about ESG in the private credit space?

The exponential growth of private credit as an asset class in the post-global financial crisis period has drawn increased attention to the factors lenders and investors look to when making key credit decisions. Readers will not be surprised to learn that private credit lenders, who frequently have closer and more collaborative relationships with borrowers and peer lenders, are increasingly requesting ESG information from borrowers and integrating ESG considerations into their investment decisions. There are compelling economic reasons behind this heightened level of interest. ESG issues, encompassing diverse elements such as greenhouse gas emissions, water management, workplace safety, data security, and compliance and risk management, may represent financially material factors. Indeed, some of today's ESG considerations have been part of traditional credit analysis. According to the market, the overwhelming impetus, and explanation for why ESG information is critical, is to respond to investor preferences and inquiry.

It is important to note, however, that there is currently a divergence in market expectations between the United States and the rest of the world. Stateside, the politicization of all things ESG, together with greenwashing concerns, have complicated efforts around ESG reporting by companies. In the European arena, however, a muscular regulatory regime has maintained pressure on market participants to incorporate ESG screening and assessment as a routine feature of their transactions, including through disclosure obligations, reporting practices, and credit risk screening. We now see some limited partners (LPs) in investment vehicles including ESG requirements in side letters with managers, including the obligation for general partners (GPs) to provide ESG reporting on portfolio investments, engage in direct dialogue with sponsors, and disclose ESG benchmarking in annual reports. As evidence of this trend, in a September 2023 report based on interviews with key stakeholders, the Principles for Responsible Investment (PRI) noted direct lenders' increased involvement in responsible investment since the COVID-19 pandemic, and underlined the major factors driving the trend, including an evolving regulatory environment, increased investor demand for ESG disclosure, and a more refined appreciation of sustainability considerations as risk factors for investors. The same PRI report noted that 42% of LPs surveyed required GPs to provide annual ESG-related disclosures of their borrowers. Similarly, in its 2021 "ESG Integration in Private Debt" survey, the European Leveraged Finance Association found that insufficient ESG disclosure by a company would lead investors to walk away from a deal. Despite the predicament faced by US managers, firms with non-US investors must

Thomson Reuters™

solve the ESG information conundrum. In this article, we will provide a general overview of the ESG landscape, and then summarize some of the primary challenges seen in this space, including diligence and data gathering.

How has the market responded to challenges around ESG disclosure?

Over the course of the past few decades, increasingly visible environmental risks, evolving geopolitical concerns, and an uncertain economic landscape have made sustainability a key focus for global governing bodies, national governments, and private market participants. This has spurred action from global regulators in the form of new rules and regulations. As a complement to these, standard-setting bodies have put forward broader frameworks and market guidance to aid market participants in their ESG education and compliance efforts. Important work has also been done to increase the availability and comparability of decision-useful ESG information on companies. There are increasingly sophisticated tools for ESG data collection, benchmarking, and value measurement. These tools continue to rely on quality data. As more regulatory reporting comes online there will be a meaningful increase in the availability of ESG information, but for the global loan market, market-driven efforts will have to serve as the engine for this.

Fortunately, this is not a problem without a solution. Players in the credit markets, with the assistance of the trade associations that represent them, have collaborated to tackle this challenge. In 2022, the LSTA, the Alternative Credit Council (the private credit affiliate of the Alternative Investment Management Association), and the PRI launched the first iteration of the ESG Integrated Disclosure Project (ESG IDP) template. The document is a reporting tool that represents a proportionate set of questions designed to solicit a global baseline of financially material ESG information which supports a lender's credit analysis. Market participants have identified a number of use cases for the template, a primary one being as a diligence tool at the origination of a loan, and others including borrower engagement, portfolio monitoring, and investor reporting processes. The key attributes of the tool are clarity and efficiency. The template offers a single, harmonized set of questions that have been identified by lenders as material to them and have been selected with the recognition that borrowers are of varying sizes and stages in their ESG journey. Moreover, lenders have been clear that they fully anticipate that many borrowers cannot answer every question today. For a borrower, the benefits are manifold and include:

- Greater certainty with respect to the ESG indicators that are most relevant to lenders.
- Efficiency gained from using a single standardized template rather than multiple, duplicative questionnaires.
- The flexibility to prepare responses outside of the accelerated timeline when they come to market.
- For companies that are just beginning to tackle ESG reporting, predictability, given the template provides a clear roadmap of how to responsibly allocate corporate resources.

In sum, we expect that sustainability considerations will remain topical for global private credit market participants and market observers as we move into Q3 and Q4 2024, and therefore the need for more and better ESG data is not going away. Loan market participants are encouraged to use the tools on offer, like the ESG IDP template, to move the ball forward. (For further information about the ESG IDP, readers may wish to learn more at https://www.esgidp.org/.)