HORIZONS

Issue 01

Spring 2024

Enter

Welcome to HORIZONS

Horizons shall showcase *innovative* trends, market analytics, regulatory developments and *LMA output in sustainability.*

Our team has been at the **forefront of sustainable lending** since 2017 and has contributed to greater standardisation and the growth of sustainable lending instruments globally. Information on this quarter's publications, plus WIP, can be found here.

Advocacy, and protection of the loan product, is a fundamental pillar on which the LMA is founded. This is especially true for sustainable finance, with its rapidly evolving regulatory ecosystem, comprised of multiple moving parts. I am therefore delighted to announce the inclusion of Sustainability Assembled, a regulatory tracker for the loan market, joining the dots for members on how best to leverage compliance with regulatory requirements to benefit from sustainable lending instruments.

Sustainable finance is founded on **innovation,** and we are always on the lookout for emerging products or initiatives to highlight. In this quarter's publication we put nature capital in the spotlight and explore the key drivers behind it becoming a core tenet of sustainable finance.

Looking ahead, we invite you all to engage with us, showcasing your thoughts and solutions to maximise liquidity in sustainability.

Gemma Lawrence-Pardew
Head of Sustainability

2023: A Year in Charts

By Maria Dikeos & Iolanda Barbati, LSEG

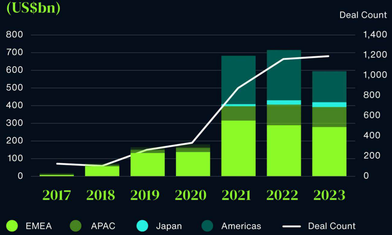
Global sustainable financing volume slowed for the third consecutive year in 2023 to log US$1.3trn, a 9% decline year-over-year.

Global Sustainable Finance Volume (US$bn)

Source LSEG LPC

2023 global sustainable loan financing volume down 17% year-over-year at US$593bn – the first year of a recorded slowdown since the market took off in 2017-2018. Japan proved the exception and saw sustainable loan volume increase 31% year-over-year to log a record setting US$27.4bn.

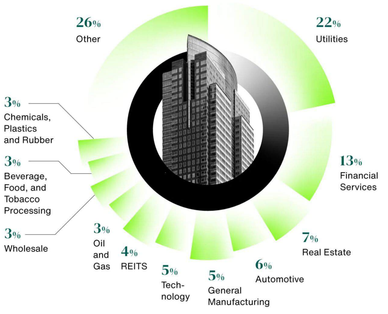
Global Sustainable Finance Loan Volume (US$bn)



Source LSEG LPC

Across regions, the utilities names represented the largest share of issuers tapping the market for sustainable loan credits at almost 22% of total issuance for the year.

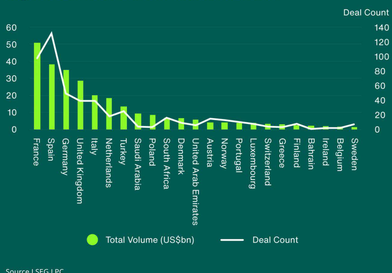
2023 Global Sustainable Finance Loan volume by Industry



Source LSEG LPC

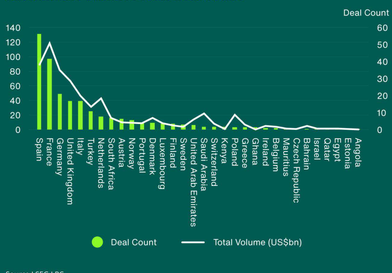
EMEA

2023 French loan market led EMEA regional Sustainable Finance loan volume



Source LSEG LPC

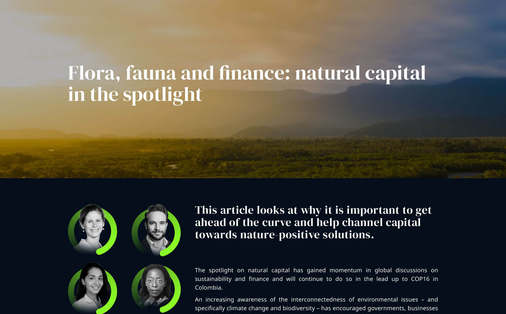
2023 Spanish loan market led EMEA regional Sustainable Finance loan deal count



Source LSEG LPC

For the analysis behind the facts, click here.

Flora, fauna and finance: natural capital in the spotlight



This article looks at why it is important to get ahead of the curve and help channel capital towards nature-positive solutions.

The spotlight on natural capital has gained momentum in global discussions on sustainability and finance and will continue to do so in the lead up to COP16 in Colombia.

An increasing awareness of the interconnectedness of environmental issues – and specifically climate change and biodiversity – has encouraged governments, businesses and financial institutions to incorporate nature-related considerations into their policies and strategies.

While sustainability issues have risen rapidly up the agenda for financial institutions, the role of natural capital and how it can be incorporated into financial markets has been less clear. However, this is a fast-moving landscape, and financial institutions are rapidly recognising the role that natural capital can play in tackling the climate emergency.

In this article, we ask market participants to explain the concept of natural capital and the key drivers behind it becoming a core tenet of sustainable finance.

What is natural capital?

Caroline Bush, Associate Director, Osborne Clarke:

"Natural capital is 'the world's stocks of natural assets which include geology, soil, air, water and all living things'. It is relied on for a wide range of services – often referred to as ecosystem services – which includes things like food, water and plant materials used for fuel, building materials and medicines as well as the climate regulation and natural flood defences provided by forests, the billions of tonnes of carbon stored by peatlands or the pollination of crops by insects."

Sumati Semavoine-Jain, Sustainability Research, BNP Paribas:

"There has been a change in the way biodiversity is perceived and tracked which has also helped elevate the topic and highlight its interlinkages with climate. Developments in this area include a shift from a species count perspective (which can be slow to track) to also focusing on the wider function of ecosystems (which can be modelled and impacted much faster). Emerging frameworks such as planetary boundaries, SDGs and ecosystem services have helped frame the issue at hand by highlighting the critical importance of understanding the interconnectedness of nature and climate. This has brought a number of new areas into focus including: land use, freshwater use, chemical use, among others."

Why is natural capital important for financial markets?

Marco DeBenedictis, Head of Structuring & Sustainable Lending, Barclays Investment Bank:

"Recognising the role of natural capital in financial markets is essential. It serves as a cornerstone for sustainable investment strategies focusing on resources such as minerals, biodiversity, water and land. Natural capital is essential for economic activity and a responsible focus offers resilience, long term value and opportunities for prudent risk management."

Sumati Semavoine-Jain:

"Under-pricing of natural capital has caused unsustainable depletion of natural resources. But progress to measure and correct externalities is under way.

Policy is one of the three catalysts we see that is accelerating this progress. The other two drivers are transparency (better data and tools uncover the large dependencies and pressures that corporates have on nature) and innovation (commercial opportunities arising in the space). Taking each of these in turn:

- Policy: Greater regulatory and policy focus is pushing corporates and investors to assess their impact on nature and shift from a purely 'extractive' perception of nature, to that of "regeneration" that values all the co-benefits healthy ecosystems provide. This shift will highlight the large dependencies that most businesses have on nature and the risk that these pose for the financial system.
- Transparency: As companies provide supply chain data across a wider set of variables, we expect a greater number of sectors to come under the radar, such as textile and cosmetics, overlooked until now regarding their impact on nature in their supply chains.
- Innovation: A number of companies have taken advantage of opportunities in the space of natural resource preservation. We see room for continued innovation and growth in a number of those enabling activities, acting as a bottom-up driver for the theme."

To what extent do investors take natural capital into account?

Caroline Bush:

"Investors have for some time now used ESG criteria to screen potential investments. These non-financial factors form part of the investment analysis, which will look to identify material risks and growth opportunities. Natural capital is of course one part of the "E" of ESG, which looks at how a company performs as a steward of nature. The criteria can also be used in evaluating environmental risks a company might face and how the company is managing those risks.

Examples include the extent to which a business's operations might be impacted by continued biodiversity loss, such as a clothing manufacturer or retailer's ability to source cotton or a food business's access to raw materials. Increased regulation in this area might also force businesses to change the way they operate, for example if they rely heavily on commodities which are linked to deforestation."

Esohe Denise Odaro, Head of ESG & Sustainability, PAI Partners:

"The global investment industry has begun to acknowledge nature-related risks alongside a growing awareness of the urgent need to preserve and replenish biodiversity for a sustainable future. The loss of biodiversity and its impact on businesses are now important considerations with wide-ranging effects on society and the global economy. With Food & Consumer as one of our core sectors, we recognize the global importance of biodiversity and PAI's responsibility to address its impacts and dependencies. For this reason, in January 2023, we identified Biodiversity as one of the three key pillars underpinning our sustainability strategy at PAI. This year, we have expanded this to Nature & Biodiversity to reflect the inclusion of other nature-related topics, particularly water stewardship – an increasingly vital global risk.

We are a member of the TNFD Forum, a network in support of the Taskforce on Nature-related Financial Disclosures (TNFD), and are an early adopter of the TNFD. Our early adoption of the TNFD signals our intention to start making public disclosures aligned with the TNFD Recommendations in 2025. Through the TNFD Forum, we work to help improve reporting on nature at both investor and portfolio company level, and through our membership of FAIRR, a food-focused sustainability network of 370+ investors ($70bn AUM), we use comprehensive Food & Consumer ESG research and insights to inform portfolio company strategies.

In October 2023, PAI unveiled BLOOM, a practical action guide that lays out five key steps designed to aid private market participants to reduce negative impacts on biodiversity and safeguard related returns. The guide supports the integration of biodiversity risk and dependency considerations both within and beyond a firm's portfolio."

Sumati Semavoine-Jain:

"Unlike carbon emissions, biodiversity doesn't have one all-encompassing variable. Hence, finding companies with nature-positive processes requires a tailored approach.

At BNP Paribas Markets 360, we differentiate between 'leaders' and 'enablers': enablers are providers of solutions; while leaders are early adopters of change. We generally focus on supply chains for leaders and revenue drivers for enablers.

To identify 'leaders', it is key to assess how companies interact with natural resources throughout the value chain: ie. how corporates source, manage, monitor and recycle them. This requires a multi-dimensional and supply chain approach. By gaining exposure to nature-related 'enablers', we tap into growth areas and diversify sector exposures. We have noticed a good level of collaboration (e.g. M&A, partnerships) happening between 'leaders' and 'enablers'.

We expect nature-related KPIs to be integrated within existing environmental screenings, which are currently climate-centric, over time, rather than natural capital being a standalone theme. If anything, nature is broader than climate, with GHG emissions one of the many supply chain indicators to track.

A good example is anti-deforestation policies being, increasingly, one of the core variables that investors assess companies on, alongside climate targets. We also expect progress on other biomes over time, beyond forests.

Beyond biodiversity, other key topics will make it onto policymaker and investor agendas in 2024 - 2025, such as plastics and oceans. Both will see greater global coordination (discussions on common goals) and benefit from further innovation and research. Both put emphasis on the need to move towards more circular business models."

How does natural capital fit within corporate transition planning?

Caroline Bush:

"Natural capital has a significant role in the carbon offsetting market. Many carbon offset projects rely on natural capital enhancement to help mitigate carbon emissions – examples include afforestation or peatland restoration. As the trend for offsetting environmental impacts continues and markets for purchasing offsetting credits develop, it is likely that the value of natural capital and the associated ecosystem services it offers will be increasingly recognised."

What are the recent key developments around natural capital?

Caroline Bush:

"Firstly, as of 12 February 2024, the biodiversity net gain regime or BNG is now mandatory in England, meaning that most developments which require planning permission will need to show a 10% increase in the biodiversity value of the site post-development against a pre-development baseline. Should a 10% increase not be achievable on-site, developers will need to off-set the impact elsewhere, either on other landholdings or through purchasing biodiversity units from a third party. There are only limited exceptions to this requirement.

Secondly, in September 2023, the TNFD launched its recommendations and guidance. These voluntary disclosures aim to help companies to account for nature in their decision making, and in the longer term to drive a shift in global financial flows towards more nature-positive outcomes. If a similar pathway is taken as for the Taskforce on Climate-related Financial Disclosures, then we may see the TNFD integrated into mandatory disclosure regimes going forward and, in any event, it is likely the TNFD's recommendations will better enable market participants to channel capital towards nature-positive investments.

A further driver in this area is the Science-based Targets Network (SBTN). While many companies may be familiar with the Science-based Targets Initiative (SBTi), which focuses on carbon reduction by requiring organisations to set a net zero target, the SBTN aims to enable targets to be set which account for impacts on both climate and nature. This may become the measure of choice for companies who are keen to show a holistic approach.

Finally, we are seeing the introduction of enhanced supply chain due diligence requirements, both at a UK and an EU level. In the EU legislation is either in place, for example the Corporate Sustainability Reporting Directive, or set to take effect imminently, such as the Deforestation Legislation. The UK is following closely behind. Together these requirements, once in place, will require a broad spectrum of companies to consider every step of their value chain and to account for and mitigate the impacts of their activities on sustainability factors."

Sumati Semavoine-Jain:

"The way forward is bottom-up data rather than a top-down approach, and TNFD will help. With more advanced data coming from corporate reporting, with full traceability of supply chain and aggregation of location-specific data, we will see increasingly advanced methodologies for judging nature positivity.

TNFD will help build out the data infrastructure, supported by the greater adoption of emerging tools by corporates: from geospatial to eDNA to help them fulfil their reporting commitments bottom-up.

It will help investors to become more sophisticated in their approach. Firstly, thanks to more detailed materiality analysis (revenues, suppliers, locations) conducted by the company, it will be easier to identify what the priority themes and KPIs to track should be. Secondly, it will be easier to put company targets into context and assess the actions companies are taking to reduce their negative impact. On target setting, SBTN will start validating freshwater and land targets after the pilot is done. TNFD and SBTN will help navigate the complexity of identifying priority areas and the factors that are impacting nature most from corporate activities."

Looking ahead

Sumati Semavoine-Jain:

"Natural capital is quickly becoming an essential consideration for the creation of government policy, reporting practices, and investment strategy. With the Global Biodiversity Framework defining the ambition in 2022, we expect efforts this year to centre on how to track, enforce and finance these common goals. In particular, we expect progress on how to value ecosystem services and aggregate that data as bellwethers for the space ahead."

Hannah Vanstone, Sustainable Finance Regulation Lead, LMA:

"Acknowledging the importance of natural capital is crucial for addressing climate change, preserving biodiversity, and ensuring the sustainability of our planet. While it may not yet be as high up the corporate agenda as carbon emissions, it cannot, and should not, be ignored. Understanding of the importance of natural capital and the interrelationship between the ecological and climate crises is increasingly being recognised.

Regulatory and voluntary, market-led initiatives are rapidly developing, forcing market participants to consider and account for the impact of their activities on nature. While some of this will not impact directly on investors and lenders, it may lead to additional costs and potentially new due diligence and risk considerations when capital is deployed. Market participants should therefore pay close attention to these developments and keep processes under review to ensure they are adequate.

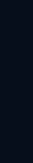
Being an early adopter may unlock key opportunities, and I therefore encourage market participants to engage with natural capital – to seek to get ahead of the curve and to help channel capital towards nature-positive solutions."

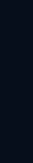
1. As defined in the Convention on Biological Diversity, the first global agreement to cover all aspects of biological diversity signed by 150 government leaders at the 1992 Rio Earth Summit.

A Year in Review

Sustainability Linked Leveraged Loans in 2023

Azzurra Camilliari, Bart Capiet & Elizabeth Campbell





In this article, we examine the trends seen in European sustainability linked leveraged loans (SLLLs) in 2023 reviewed by Reorg.

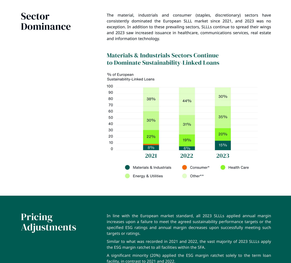
In short:

- SLLL volumes increased in 2023 to €15.6 billion, but issuance halved to 24% from 53% in 2022.
- 2023 SLLLs offered a modest 7.5 bps cumulative upward and downward adjustment to the margin compared with 13 bps in 2022.
- SLLLs in 2023 enhanced transparency through more reporting and external verification requirements; and
- Environmental and social concerns dominated in 2023's SLLLs.

Market Overview

Despite turbulent market conditions, political unrest and increased regulatory requirements, 2023 saw European SLLL volumes' increase 17% year-over-year to €15.6 billion, representing more than double the volume of 2022 sustainability-linked bonds.

Sustainability Linked Loans Volumes Higher than Sustainability Linked Bonds Volumes in 2023



The return of investor confidence in 2023's leveraged loans' market did not extend to SLLL issuance. While volume increase is to be celebrated, 2023 SLLL issuance[1] – as a proportion of broadly syndicated leveraged loan issuance – halved to 24% from 53% in 2022. We note that three loans that came to market with sustainability-linked provisions in 2023 had those mechanics removed during their 2024 maturity extensions and refinancing needs acting as key drivers for primary market issuance in 2023. It is possible that borrowers preferred to focus on extending their maturities rather than ESG issues, as setting an SLLL can be time consuming.

Sustainability Linked Issuance Decreased in 2023

Source: DMA Covenants by Reorg® - 2024 Reorg. All Rights Reserved. Reorg® is a registered trademark of Reorg Research Ltd.

Sector Dominance

The material, industrials and consumer (staples, discretionary) sectors have consistently dominated the European SLLL market since 2021, and 2023 was no exception. However, while these prevailing SLLLs continue to spread their wings and 2023 saw increased issuance in healthcare, communications services, real estate and information technology.

Materials & Industrials Sectors Continue to Dominate Sustainability Linked Loans

Pricing Adjustments

In line with the European market standard, all 2023 SLLLs applied annual margin increases upon a failure to meet the agreed sustainability performance targets or the specified ESG ratings and annual margin decreases upon successfully meeting such targets or ratings.

Similar to what was recorded in 2021 and 2022, the vast majority of 2023 SLLLs apply the ESG margin ratchet to all facilities within the SFA.

A significant minority (29%) applied the ESG margin ratchet solely to the term loan facility, in contrast to 2021 and 2022.

ESG Margin Ratchet Applies to All Facilities in Vast Majority of 2023 Sustainability Linked Loans

Source: DMA Covenants by Reorg® - 2024 Reorg. All Rights Reserved. Reorg® is a registered trademark of Reorg Research Ltd.

In 2023, the range of the cumulative adjustment to the sustainability-linked margin is slightly tighter compared with the previous years, ranging from +/-5 bps to +/-15 bps.

2023 SLLLs exhibited less appealing rewards than the ones offered in 2022 SLLLs, with 40% of 2023 SLLLs offering a modest +/-7.5 bps adjustment, compared with 47% of 2022 SLLLs which offered a +/-10 bps adjustment.

Cumulative Margin Adjustments	2020	2022	2023
2 bps	3%	0%	-
2.5 bps	0%	7%	-
5 bps	11%	0%	20%
7.5 bps	47%	13%	40%
10 bps	32%	47%	27%
12.5 bps	3%	0%	-
15 bps	8%	7%	13%

KPIs

As it was the case in 2022, environmental KPIs feature in almost all 2023 SLLLs (93%), Social KPIs remain consistent with 2022 levels, featuring in 33% of 2023 SLLLs, but governance KPIs dropped to 20% of 2023's SLLLs.

Sustainability Linked Issuance Decreased in 2023

Source: DMA Covenants by Reorg® - 2024 Reorg. All Rights Reserved. Reorg® is a registered trademark of Reorg Research Ltd.

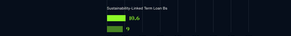
2023 welcomed the inclusion of new KPIs in a handful of SLLLs, including KPIs focused on air quality (13%) and social concerns such as health and safety in the workplace (20%) and working conditions (7%). This is a positive sign, showing that from an "E" and "S" perspective, not only climate change and diversity issues matter.

Climate Change Most Popular KPI in 2023 Sustainability Linked Loans, Social KPIs Increase

Source: DMA Covenants by Reorg® - 2024 Reorg. All Rights Reserved. Reorg® is a registered trademark of Reorg Research Ltd.

From a numbers perspective, largely consistent with the trend seen in 2022 and 2021, 44% of 2023 SLLLs featured three KPIs.

Sustainability Linked Loans Stay Focused on Environmental KPIs



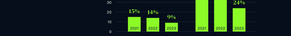
Source: DMA Covenants by Reorg® - 2024 Reorg. All Rights Reserved. Reorg® is a registered trademark of Reorg Research Ltd.

Disclosure, Reporting and External Verification

Positively in 2023, SLLLs have enhanced transparency through more rigorous disclosure, reporting and external verification requirements.

The number of borrowers providing sustainability reports, either from an independent third party (3%) or the company (63%) has significantly increased to 70% in 2023 compared with 47% in 2022. This is a positive development in terms of transparency as these reports are intended to provide investors with more fulsome information, including the methodology on how calculations have been made when asserting performance and any adjustments to the KPIs/SPTs.

2023 Disclosure Requirements in Sustainability Linked Loans Improve from 2022



Source: DMA Covenants by Reorg® - 2024 Reorg. All Rights Reserved. Reorg® is a registered trademark of Reorg Research Ltd.

Another positive development toward ESG transparency is that the number of SLLLs that require an external verification with respect to the borrower's determination of SPTs increased to 70% in 2023 from 60% in 2022 and 2021.

Sleeping Sustainability Linked Leveraged Loans

Since 2021, we have seen senior facility agreements where the parties wanted to offer an SLLL, but couldn't agree on the KPIs/SPTs at the time of loan origination. So instead they agreed to postpone the setting to a later time. These SLLLs are known as "sleeping SLLLs".

As illustrated below, sleeping SLLLs in the European leveraged market have continued to grow since 2021, representing 35% of 2023 SLLLs.

Sleeping SLLLs could possibly have a positive impact on the ESG space. They could encourage more borrowers to opt for sustainability-linked financing where it would be difficult to complete all the necessary related work at the time the deal launches. They could also provide flexibility within the sustainability-financing instrument to allow parties to conduct further due diligence in establishing the SPTs/KPIs that should apply.

Care should be taken to ensure that when set in the future, the KPIs/SPTs are meaningful and ambitious (for example, they should not be set at a level that the borrower could easily meet in the ordinary course of business). As little as other loan documentation and loans is currently sleeping at 2023.

Further guardrails relating to inclusion of sleeping mechanics in an SLLL are set out in the LMA's Best Practice Guide for Sustainability-Linked Leveraged Loans published in collaboration with the European Leveraged Finance Association in October 2023.

Sleeping Sustainability Linked Loans Continue to Grow in 2023

Source: DMA Covenants by Reorg® - 2024 Reorg. All Rights Reserved. Reorg® is a registered trademark of Reorg Research Ltd.

Looking Ahead: 2024 Outlook

Despite the return of investor confidence in 2023 for European leveraged loans generally, this did not really extend to sustainability-linked instruments as issuance of SLLLs decreased as a proportion of broadly syndicated leveraged loan issuance. However, sentiments for SLLLs in 2024 remain confident given their volume increase in 2023.

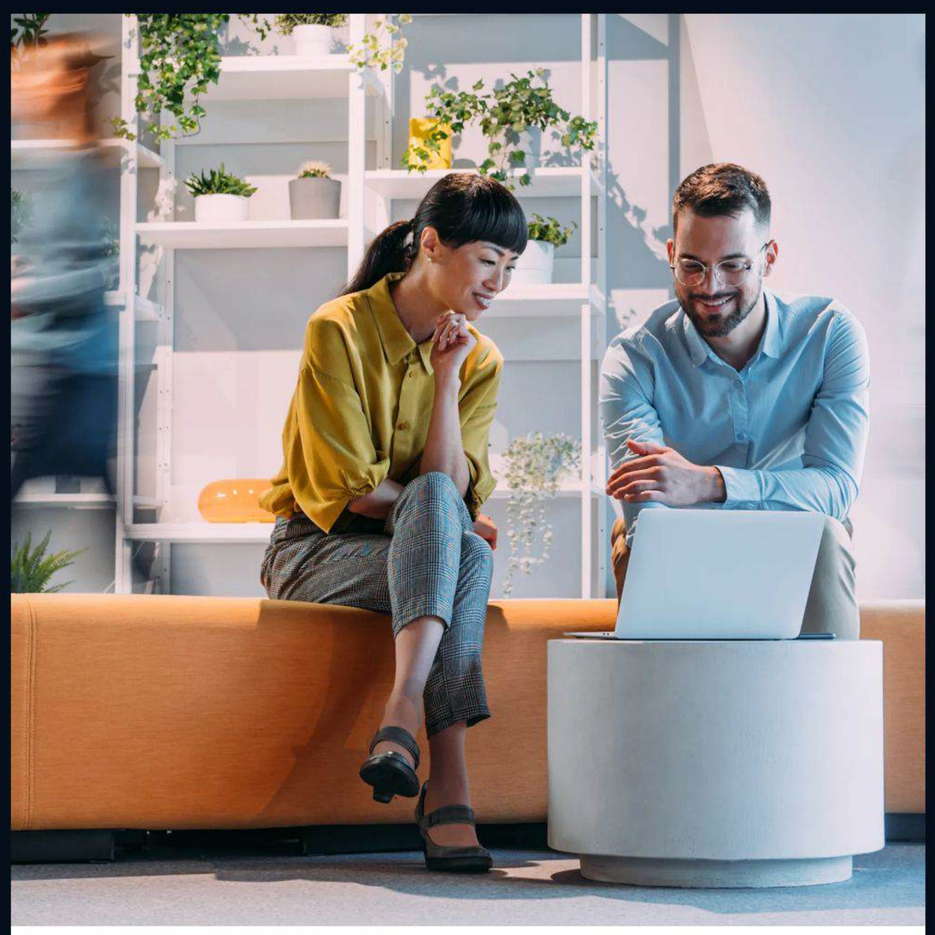
In addition, following the inclusion of additional KPIs (for example, air quality, health and safety in the workplace and working conditions) by borrowers in 2023, we hope to see more social and governance KPIs added to the list of those covered by sustainability-linked instruments in 2024, despite the perceived difficulties in measuring the actual impact of social and governance KPIs.

Finally, and regarding sleeping mechanics, we expect that, as more participants have been through the process of having struggled to reach an agreement, there will be welcome to enhanced transparency through more reporting and external verifications, which featured in 2023 SLLLs, we hope this trend for improvement continues throughout 2024 and beyond.

---

1. As a proportion of the overall European leveraged loans market as captured in Reorg's primary market database.
2. According to Reorg's Q4 2023 Private Credit Report, European term loans B issued in 2023 totaled €89.6 billion, of which €77.2 billion (86%) were covenant-lite. See Reorg's Quarterly Private Credit Report.
3. As a proportion of European leveraged loans reviewed by DMA Covenants.

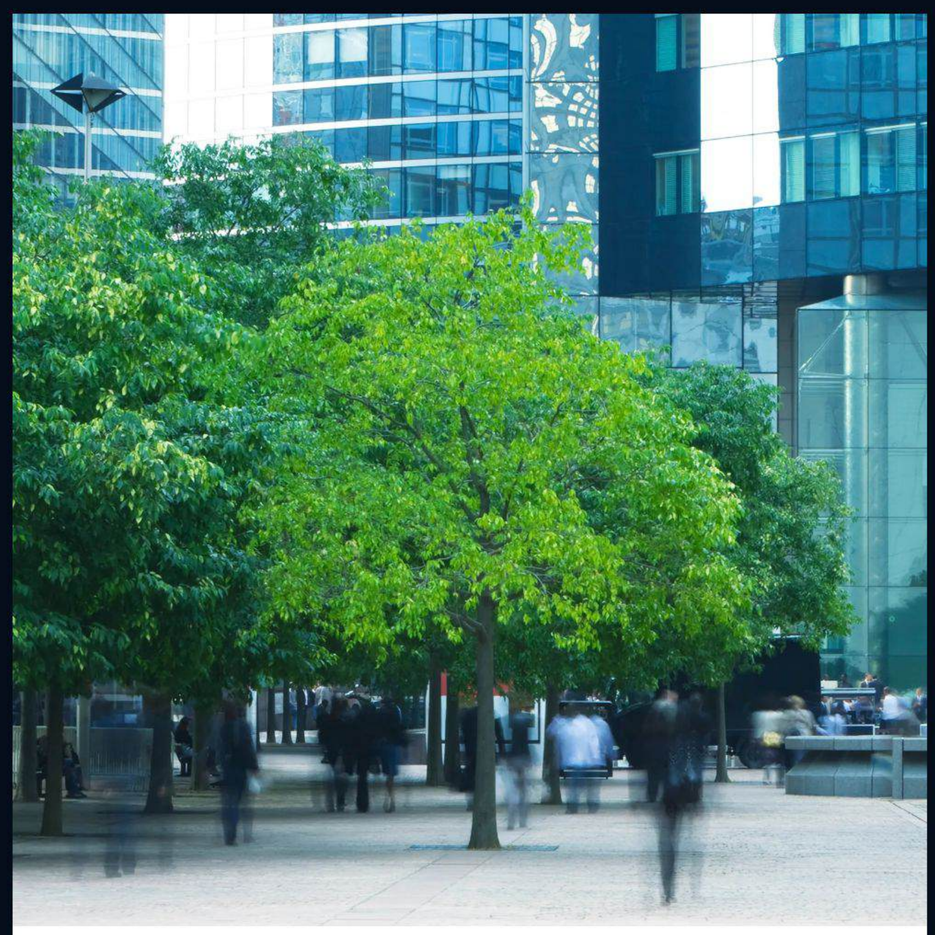
LMA Articles



Funds Finance

A summation of the key drivers, challenges and opportunities behind the uptake of SLLs in fund finance transactions.

Read more



External Review

An exploration of the challenges and opportunities for those navigating the alphabet soup of external review.

Read more

Integrating ESG into Fund Finance

By Gemma Lawrence-Pardew, Head of Sustainability, LMA

ESG factors are becoming increasingly prominent in fund finance transactions as fund managers and their lenders come under growing pressure to demonstrate how they are tackling the climate emergency and other ESG issues.

In this article, we consider the key drivers behind the uptake of sustainability-linked loans in fund finance transactions, the challenges and the future landscape. These are explored in more detail in our new joint publication, "A Guide to the Application of the SLLP[1] in Fund Finance"[2] (the Guide).

A Recipe for Success

It is no surprise that funds are looking to incorporate sustainability credentials into their investment processes given the current climate of stricter regulatory reporting requirements, increasing stakeholder awareness, and the growing understanding that ESG is inherently connected to higher returns.

Lenders are similarly eager to lead the charge in promoting the transition through their financial products, for example by boosting the quantity of loans to finance green or social projects directly (through use of proceeds loans), and/or enhancing a borrower's sustainability profile (through sustainability-linked loans).

These parallel forces have created an environment in which innovative finance structures have flourished at the intersection of ESG and fund finance.

"When you combine the lenders and the funds industry's ESG motivations, you have a recipe that works"

Chiva Lai, Senior Director, APLMA.

Guardrails Against Greenwashing

Innovation, however, is typically followed by a period of consolidation. As such, we expect fund finance structures to coalesce around established market standards and best practices, including the Green, Social and Sustainability-Linked Loan Principles[3] (the Principles).

"The Principles create vital safeguards preserving the integrity of the sustainable loan market and are increasingly acknowledged for creating guardrails against greenwashing. As sustainability-linked features take increasing prevalence in fund finance transactions, it is important that the core components of the SLLP be adhered to and this is the focus of the Guide produced."

Tess Virmani, Head of Policy, LSTA.

Addressing the Challenges

The Guide seeks to address the most prominent challenges faced in applying the SLLP to fund finance facilities. These include:

(a) the difficulty of setting key performance indicators due to a fund's limited physical operations, uncertainty of investment pipeline or a lack of consistent metrics across a fund's underlying investments;

(b) limited historical ESG data on borrowers, the fund or sponsor, as applicable, and the underlying investments; and

(c) shorter tenors relative to other types of financings.

Furthermore, jurisdictional anomalies, varying sophistication of funds and (potentially) cost-prohibitive external reviews all add to the complexity of these structures.

However, none of these challenges are insurmountable.

"This is a dynamic and innovative market, where multiple strategies have been adopted to progress increasing adoption of sustainability-linked loan provisions into fund finance transactions. These strategies are by no means exhaustive and we expect to see further adaptation take place moving forward as drivers to adopt ESG continue to surge ahead."

Deborah Low, Partner at Haynes Boone.

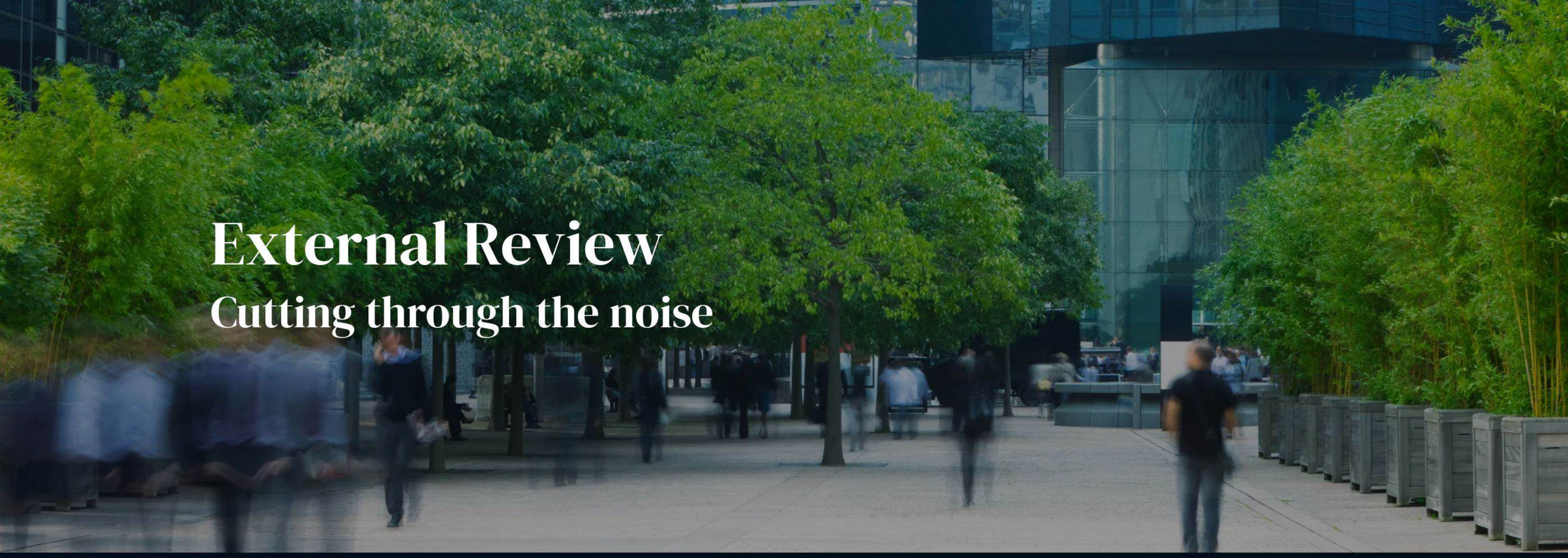
As this market develops, it is important to acknowledge that, while there is no one-size-fits-all solution, the SLLP provide a framework to help to ensure the credibility of sustainable fund financing structures.

Moving Forward

The Guide focuses solely on the application of the SLLP and does not drill down into the use of proceeds instruments, i.e. green and/or social loans. Use of proceeds instruments are better suited to net asset value facilities, where the fund has a mature portfolio to borrow against, and which can be used to finance an acquisition.

Moving forward, it is for the Associations to consider whether a second publication, addressing application of use of proceeds structures, is required, and we invite market feedback on this point.

1. Sustainability-Linked Loan Principles, February 2023
2. https://www.lma.eu.com/application/files/4417/0963/8357A_Guide_to_the_Application_of_the_SLLP_in_Fund_Finance.pdf
3. The Principles, and supporting Guidance, can be found at https://www.lma.eu.com/sustainable-lending/resources



External Review

Cutting through the noise

By Hannah Vanstone, Sustainable Finance Regulation Lead, LMA

The world of sustainable finance provides a veritable feast of acronyms, where terms are sometimes used interchangeably – or even to mean entirely different things.

For sustainable finance professionals, it can at times be challenging to keep afloat in this alphabet soup. For those who are looking to set out on their sustainable finance journey, it may even be enough to make you lose your appetite for sustainable finance altogether.

Based on the feedback we received over recent years, one area more than others seems to cause considerable confusion for market participants – the use of external reviews. Indeed, a project that started as a simple update to the 'External Review Guidance' (the Guidance) on account of the updates to the Green, Social and Sustainability-Linked Loan Principles in 2023 quickly turned into an extensive re-write following initial discussions with our dedicated working party.

There were many reasons why such an extensive re-write was required, including:

- the market for external reviews has developed significantly in recent years, with market conventions still evolving rapidly;
- sustainable finance products themselves have developed at pace, including the addition of the mandatory verification requirement to the Sustainability-Linked Loan Principles in 2021; and
- a changing environment over recent years in which scrutiny from a range of stakeholders in relation to sustainability claims has increased considerably.

The updated Guidance seeks to cut through some of the noise in this area, to try to bring clarity to the meaning and content of the different types of external reviews (including second party opinions, verification and ratings/scores), whilst recognising that there are still some grey areas in between where market practice is still developing.

The Guidance also highlights industry standards and industry-wide codes of conduct which may apply to external reviews, as well as best practice on the disclosure of external reviews in relation to sustainable lending transactions.

We expect the external review market to continue to develop at pace.

"Market participants have highlighted a number of challenges in obtaining external reviews in relation to sustainable finance transactions. This is a fast-moving area where market practices are developing rapidly and new regulation, including the proposed ESG Ratings Regulation recently agreed by the Council and the European Parliament, is already having an impact. We expect to see external review practices continue to mature to meet the demands of the market and increased regulation over the next few years."

Gemma Lawrence-Pardew, Head of Sustainability, LMA.

For those who are able to navigate the alphabet soup, external reviews can unlock many opportunities, improving access to sustainable finance products such as sustainability-linked loans and helping to ensure the credibility and transparency of these transactions.

We would like to thank the LSTA and the APLMA, as well as our dedicated working party and ESG Committee for their support and assistance in preparing the updated Guidance.

Sustainable Finance Regulatory Update

Navigating the key sustainable finance regulations across EMEA

Sustainability Assembled

2024 started with the news that for the first-time global warming exceeded 1.5C across an entire year (February 2023 to January 2024)[1].

This will undoubtedly put more pressure on private capital to accelerate the global transition in order to slow global warming. With that pressure will come regulation.

With that in mind, we have created Sustainability Assembled, our new regulatory tracker, to highlight key regulatory updates which affect the loan market as well as changes to ESG standards and major developments in the ESG sector.

In addition, we have established a dedicated Sustainable Finance Regulatory Committee to gather our members' expertise as we navigate the wave of sustainable finance regulation rolling across EMEA, and to ensure the loan market can continue to operate effectively and deliver liquidity for the transition with the required urgency. For information on our recent responses to regulatory consultations, see here.

Your engagement on this topic is paramount and we therefore invite you to join our discussion on regulatory issues relating to sustainable finance.

Hannah Vanstone
Sustainable Finance Regulation Lead, LMA

The information on the Site is not provided for any specific purpose and does not constitute legal, regulatory, financial or other professional advice, and should not be relied upon or treated as a substitute for specific advice relevant to particular circumstances. Whilst the LMA aims to keep information on the Site current, it is provided "as is" and there are no responsibilities or warranties (express or implied) as to the accuracy, quality or fitness for any particular purpose of the Site or its contents.

1. EU's Copernicus Climate Change Service

Sustainability Assembled

Legal and Regulatory Market Updates Q1 2024

Table of contents

- Sustainability Regulation
- ESG Standards
- ESG Funds
- Sector Development and News
- Toolkits and Guidance
- ESG Consultations

ESG Standards: Spotlight on Biodiversity

GRI publishes updated Biodiversity Standard

On January 25, 2024, Global Reporting Initiative (**GRI**) published a major update to its biodiversity standard by expanding and replacing GRI 304: Biodiversity 2016 with GRI: 101: Biodiversity 2024 (**Biodiversity Standard**).

The Biodiversity Standard helps companies to understand the business practices and decisions which lead to biodiversity loss, where the relevant impact occurs in a value chain and biodiversity-related impact can be effectively managed. The standard emphasises the importance of reporting significant impacts, not all impacts.

GRI 101: Biodiversity 2024 comes into effect on 1 January 2026 and is required for all reporting on biodiversity published on or after 1 January 2026.

Changes to the Biodiversity Standard

- New biodiversity-related disclosures across supply chains.
- New requirements to understand biodiversity-related impact on people.
- A new disclosure to report on the direct causes of biodiversity loss: land and sea use, exploitation of natural resources, pollution, and invasive alien species.
- New biodiversity-specific management disclosures including policies developed to halt and reverse biodiversity loss.

Alignment

- International goals such as the Kunming-Montreal Global Biodiversity Framework
- Taskforce on Nature-related Financial Disclosures (TNFD) disclosure
- ESRS E4 Biodiversity and ecosystems.

Taskforce on Nature-related disclosures publishes draft sector-specific guidance

On December 7, 2023 the Taskforce on Nature-related Financial Disclosures (TNFD) published draft sector-specific guidance for nine sectors (Guidance).

Guidance for the following nine high-impact industries is included: Oil and gas; Metals and mining; Food and agriculture; Forestry and paper; Electric utilities and power generators; Aquaculture; Biotechnology and pharmaceuticals; and Chemicals.

The TNFD invites feedback on the draft Guidance until 29 March 2024 and plans to publish the final versions in Q3 2024.

Joining the Dots:

The impact of biodiversity loss on the business and financial sector is well documented. The JRC Working Paper "Loan pricing and biodiversity exposure: Nature-related spillovers to the financial sector" is a reminder that biodiversity loss poses not only ecological risks but also adverse economic and financial impact by reducing the availability of natural resources and increasing costs.

Sustainable loan products can play an important part in addressing biodiversity loss by financing relevant projects through green loans or by selecting relevant key performance indicators (**KPIs**) in sustainability-linked loans. The LMA refers to biodiversity in the context of green loans explicitly recognising biodiversity conservation as a category of eligibility for Green Projects and The Global Reporting Initiative Standards (**GRI Standards**) are referred to in the Sustainability-Linked Loan Principles and related Guidance as a way to consider the materiality, parameters, and scope of key performance indicators.

This revision of the Biodiversity Standard offers the opportunity of examining how ESG standards can be used not only for reporting and disclosure but as a tool to structure relevant loan products and ensure robust terms. Key takeaways include:

- materiality and ambition of KPIs in sustainability-linked loans is crucial. The Biodiversity Standard includes guidance on how to determine the most significant impacts on biodiversity which in turn can inform the selection of KPIs;
- when considering biodiversity as a potential KPI, the Biodiversity Standard can assist parties in determining the parameters and scope of a biodiversity-related KPI and the criteria to be applied for evaluating and selecting an eligible green project under a Green Loan; and
- the additional tools and approaches included in the GRI Biodiversity Standard can assist market participants and ESG consultants to increase understanding and assessment of potential biodiversity impact and relevant data (e.g., ENCORE tool, SBTN Materiality Screening Tool, TNFD LEAP approach, and WWF Biodiversity Risk Filter).

Sustainability Assembled

Legal and Regulatory Market Updates Q1 2024

Table of contents

- Sustainability Regulation
- ESG Standards
- ESG Funds
- Sector Development and News
- Toolkits and Guidance
- ESG Consultations

ESMA Update: ESG Fund Names

Following its consultation in November 2023, in December 2023, ESMA published a statement providing an update on its plans relating to fund names using ESG or sustainability related terms. Having considered the feedback on the consultation ESMA has agreed amendments to the "Guidelines on funds' names using ESG or sustainability terms".

The Guidelines are expected to be approved and published in Q2 2024, subject to the timing of the publication of the AIFMD and UCITS Directive revised texts.

Impact Investing: Do SDG Funds fulfil their promise?

On 1 February 2024, ESMA published its report titled "Impact Investing - Do SDG Funds fulfil their promise" setting out a summary and approach that market participants can use when considering "SDG funds" and "impact investing".

Joining the Dots

Impact investing has long been seen as essential to achieving the EU's sustainability objectives.

There is no one universally accepted definition of "impact investing". However, it is commonly accepted that a positive and measurable contribution to the environment and/or society is required alongside financial return.

The UN SDGs are one of the most commonly used frameworks in the context of impact investment and finance. Detailed indicators are set for each of the 17 SDGs and the United Nations Global Compact and OECD, for example, continue to build out this framework.

However, disclosure, reporting and analysis of SDG alignment remains challenging and impact claims often loosely refer to international goals such as the Paris Agreement and the UN SDGs without including details relating to the implementation of a relevant strategy and/or analysis and consideration of a methodology to ensure alignment with specific SDGs.

The increased focus on sustainability-related terms has extended to the use of and reference to terms such as "impact" and "SDGs" and "SDG alignment".

Sustainability Assembled

Legal and Regulatory Market Updates Q1 2024

Table of contents

- Sustainability Regulation
- ESG Standards
- ESG Funds
- Sector Development and News
- Toolkits and Guidance
- ESG Consultations

ESG Reports, Sector Developments and News

ESMA Report on Trends, Risks and Vulnerabilities

On 31 January 2024, ESMA published its Report on Trends, Risks and Vulnerabilities (**Report**) referring to the confluence of interrelated market risk drivers in 2H 2023: longer interest rates, geopolitical and peripheral risks, real-estate valuations, greenwashing and use of social media.

The Report highlights greenwashing and related malpractices as an amber risk driver which is undermining the credibility of green finance with the potential to undermine investor confidence. According to the Report, in 2023 ESG investing and growth of ESG-related instruments has been affected by a number of factors including greenwashing risks and growing public scrutiny of sustainability claims.

The Report also suggests that the broad definition of Article 8 SFDR funds may have led investors to opt for alternative investments and the use of ESG-related terms in fund names may be becoming an important distinguishing factor for investors to opt for alternative investments and the use of ESG-related terms in fund names may be becoming an important distinction.

A key development highlighted by the Report is the increase in public sustainability-related information being reported and disclosed by EU supervised entities including taxonomy aligned data.

Risks from misalignment of banks' financing with the EU climate objectives – Assessment of the alignment of the European Banking Sector

"Among the 95 significant institutions within the scope of this analysis, a striking 90% are found to be misaligned, increasing their transition risk."

In January 2024, the European Central Bank (**ECB**) published a report "Risk from misalignment of banks' financing with EU climate objectives" (**Report**) which examines transition risks and the effect of such risks on the credit portfolios of financial institutions.

Higher carbon prices, dependency on energy prices, asset stranding, environmental regulations and changing consumer preferences mean corporates in energy intensive or CO2-intensive sectors (particularly those who have not taken steps for decarbonising) could experience reduced competitiveness resulting in an increased increase risk of defaults. In the event of a delayed transition, government intervention may require rapid compliance resulting in a higher risk of default.

Assessing this risk is critical for financial institutions. Financial institutions and central banks are increasingly scrutinising 'alignment assessments' i.e. the difference between a corporation's production projection and targets set under a decarbonisation pathway. Misalignment indicates that a corporate is transitioning slower than is required under the decarbonisation pathway.

The ECB invites banks to apply the assessments, approaches and methodologies used in the Report to further develop their own alignment assessment capabilities and meet disclosure requirements under the European Banking Authority's Implementing Technical Standards on Pillar 3.

ECB steps up climate work with focus on green transition, climate and nature-related risks

The European Central Bank (ECB) has announced its intention to expand its work on climate change, with a focus on transition risk and impact, physical impact of climate change and adaptation and risks resulting from nature loss and degradation. The ECB will also continue to improve climate-related indicators, risk monitoring and disclosures, and will continue to do its part to help the EU achieve its climate-related ambitions. Its plan is to regularly review its actions in that context and ensure they are fit for purpose.

A review of the ECB's planned work programme can be found in the Climate and Nature Plan 2024-2025 Annex: Our Roadmap.

Sustainability disclosure and labelling: FCA launches new webpage

FCA launched a new webpage, which details the sustainability disclosure and labelling regime for financial firms. The webpage provides key information for various types of firms involved in this market, including how FCA-authorised firms should understand the regime and comply with the anti-greenwashing rule.

Q&A: Communications on 2040 target to achieve 2050 climate neutrality and on industrial carbon management

The Commission has published a communication which begins the process of preparing 2040 targets to achieve climate neutrality and industrial carbon management and also launches a broad political debate and dialogue with stakeholders and citizens. The Commission has also published a detailed impact assessment on possible pathways to reach climate neutrality by 2050 which will inform this debate and any future legislative and policy choices.

Transition Plan Taskforces's mandate extended

The Transition Plan Taskforce's mandate has been extended by HM Treasury until at least 31 July 2024 and potentially for a further with a 3 months to end of October 2024, in order to support the Transition Finance Market Review.

Sustainability Assembled

Legal and Regulatory Market Updates Q1 2024

Table of contents

- Sustainability Regulation
- ESG Standards
- ESG Funds
- Sector Development and News
- Toolkits and Guidance
- ESG Consultations

Toolkits and Guidance

In this section, we highlight recently launched sustainability-related toolkits and guidance created by trade associations, standard setters and relevant network organisations.

Green Lease Toolkit published

On 29 January 2024, the Better Business Partnership launched an updated Green Lease Toolkit co-created by and for property owners, occupiers, and legal experts in order to support sustainability across the commercial real estate sector. Key features include legal clauses covering nearly 20 critical areas like building management, circular economy, waste management and renewable energy and specific guidance and drafting notes.

Sustainability-Related Financial Disclosures Toolkit launched for Stock Exchanges

The Sustainable Stock Exchanges Initiative, along with its partners have created a "Sustainability-Related Financial Disclosures Toolkit" to support exchanges and market participants to implement IFRS Sustainability Disclosure Standards. The toolkit, endorsed by Sustainability Disclosure Standards has been developed by the International Sustainability Standards Board (**IFRS ISSB**), features new "Model Guidance" and a range of publications and includes training resources. Further tools will be added to continue on-going support to stock exchanges and their markets.

The Third GRI and IFRS publish Interoperability considerations for GHG emissions when applying GRI Standards and ISSB Standards

In January 2024, the Global Reporting Initiative (**GRI**) and the International Financial Reporting Standards (**IFRS**) jointly published a new analysis and mapping resource: "Interoperability considerations for greenhouse gas (GHG) emissions when applying GRI Standards and ISSB Standards". Specifically the resource sets out the areas of interoperability between GRI 305: Emissions 2016 and IFRS S2 Climate-related Disclosures that a company should consider when measuring and disclosing Scope 1, Scope 2 and Scope 3 greenhouse gas emissions in accordance with both standards.

According to the GRI and IFRS, the requirements under GRI 305 and IFRS S2 demonstrate a high degree of alignment and alignment can be further enhanced depending on how an organisation applies them. The toolkit does however also indicate areas of divergence (including for example requirements relating to segregation of data and the use of specific metrics for example).

New Guidance from PRI: Corporate Governance, Human Rights

The Principles for Responsible Investment have released two new guides for asset owners:

- Corporate Governance Guide: explains why good corporate governance matters for investors. It highlights key principles, regional variations, and the approaches that asset owners can take to promote good governance within the companies they invest in. These approaches include influencing company policies, strategies, and stewardship practices, along with using proxy voting and engagement strategies. The guide also includes real-world examples; and
- Human Rights Guide: this focuses on how asset owners and advisors can integrate human rights considerations into their investment decisions. It references the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises, and outlines how asset owners can ensure their investment managers understand and implement their human rights commitments.

ISSB issues guidance on standards

On 22 February 2024, the International Sustainability Standards Board (**ISSB**) released two resources to support jurisdictions in adopting or otherwise using their sustainability standards:

- Preview of the Inaugural Jurisdictional Guide for the adoption or other use of ISSB Standards: the guide sets out information for jurisdictions which are considering incorporating ISSB standards into their legal and regulatory frameworks outlining the different approaches that can be taken. The final version of this guide will be published in H12024; and
- Jurisdictional consultations overview: This report summarises ongoing and completed consultations with various jurisdictions regarding sustainability-related disclosures.

ISDA launches Sustainability-linked Derivative clauses

ISDA has launched a clause library for sustainability-linked derivatives (**SLDs**), designed to provide standardised drafting options for market participants to use when negotiating SLD transactions with counterparties. A survey in 2022 indicated that there is support for developing the sustainability-linked derivative product which, like the Sustainability-Linked Loans, uses key performance indicators to achieve ESG targets.

Sustainability Assembled

Legal and Regulatory Market Updates Q1 2024

Table of contents

- Sustainability Regulation
- ESG Standards
- ESG Funds
- Sector Development and News
- Toolkits and Guidance
- ESG Consultations

ESG Consultations

Consultations

Date of the consultation	Consultation title	Link to the consultation	Consultation purpose	Deadline for response
13 December 2023	EIOPA – consults on prudential treatment of sustainability risks	Link	EIOPA published a consultation paper on the prudential treatment of sustainability risks under the Solvency II Directive (2009/138/EC). Stakeholders are invited to provide their feedback by responding to the questions included in the following link: Survey Link	22 March 2024
18 January 2024	European Banking Authority – EBA consults on management of ESG risks guidelines under CRD IV	Link	EBA published a consultation paper setting out draft guidelines on the management of ESG risks. Those include guidelines on minimum standards and reference methodologies for the identification, measurement, management and monitoring of ESG risks by institutions. Stakeholders are invited to provide their feedback by responding to the questions included in the following link: Survey Link	18 April 2024
22 January 2024	EFRAG – EFRAG consults on EU sustainability reporting standards (ESRS) for listed and non-listed SMEs	Link	EFRAG published a consultation on its exposure drafts of EU sustainability reporting standards for listed small- and medium-sized enterprises and for non-listed SMEs. Stakeholders are invited to provide their feedback by responding to the questions included in the following link: Survey Link	21 May 2024
29 January 2024	EBA survey on classification methodologies for exposures to ESG risks	Link	The EBA has launched an industry survey to receive input from credit institutions on their methodologies to classify exposures to environmental, social and governance (ESG) risks, as well as on the accessibility and availability of ESG data for this purpose. Stakeholders willing to take part in the survey need to contact the EBA and express their interest via this Email address and following they will be given access to the survey.	29 March 2024

Projects

The Green, Social and Sustainability-Linked Loan Principles create the foundations upon which this market can thrive and we continue to work to produce greater clarity, transparency and granularity around these Principles to drive forward sustainable lending liquidity.

This quarter has seen the following activity:

Q1 Publications	WIP
Second Edition of External Review Guidance for GSS Loans – with APLMA and LSTA	Mandate Letter for SLL Sustainability Co-ordinator
A Guide to the Application of the Sustainability Linked-Loan Principles in Fund Finance – with APLMA, FFA and LSTA	Guidance on Sustainability-Linked Loan (Refinancing) Bond – with ICMA Model Provisions for Use of Proceeds Transactions

Regulatory Submissions

Q4 2023	Q1 2024
European Commission's Targeted Consultation on the Sustainable Finance Disclosures Regulation (SFDR), where we stressed, among other things, the need for further clarity around certain key concepts under the SFDR as well as a need for greater interoperability across global reporting regimes.	UK Financial Conduct Authority's consultation on its anti-greenwashing rule guidance, where we requested, among other things, clearer guidance on market best practice to ensure that market participants understand the correct processes to follow to avoid inadvertent greenwashing.

Resources

Regulatory Submissions

Q4 2023

European Commission's Targeted Consultation on the Sustainable Finance Disclosures Regulation (SFDR), where we stressed, among other things, the need for further clarity around certain key concepts under the SFDR as well as a need for greater interoperability across global reporting regimes

Q1 2024

UK Financial Conduct Authority's consultation on its anti-greenwashing rule guidance, where we requested, among other things, clearer guidance on market best practice to ensure that market participants understand the correct processes to follow to avoid inadvertent greenwashing.

Investors

Investors are increasingly expecting and requesting information regarding Taxonomy-alignment in order to assess an organisation’s transition plans in line with their own sustainability commitments and targets. Taxonomy-alignment is also considered by investors when applying or assessing voluntary industry guidance such as the LMA sustainable loan principles and evaluating the sustainability or green credentials in investment products including those driven by other regulation such as the Sustainable Finance Disclosure Regulation.

Background to ESG Rating Regulation

The proposed regulation applies to an entity whose occupation includes the offering and distribution of ESG ratings or scores on a professional basis. ESG ratings are opinions or scores (or a combination) which, irrespective of labelling (i) relate to an entity, financial instrument, financial product or the ESG profile or characteristics of an undertaking or its exposure ESG risks or ESG impact; (ii) is based on an established methodology or defined ranking system of rating categories and (iii) is provided to third parties. The regulation applies to any such ESG ratings issued by ESG rating providers operating within the EU which are disclosed publicly or distributed to EU regulated financial undertakings, undertakings that fall under the Accounting Directive or EU or member state public authorities.

Further details of exemptions are provided in the proposed regulation which include credit ratings issued under the Credit Ratings Regulation, private ESG ratings and those used for internal purposes as well as the provision of raw ESG data which does not involve a process of rating, scoring, modelling or analysis.

European Securities and Markets Authority is responsible for the on-going supervision of EU based ESG rating providers and is required to maintain a register that contains information on all authorised EU ESG rating providers and any relevant third-country ESG rating providers.

The proposed regulation clarifies the mechanisms for third-country ESG rating providers intending to operate within the EU and includes lighter, temporary regime for small ESG rating providers for a period of three years.

Credit institutions

The Taxonomy Regulation has been integrated into credit institutions' green and sustainability-linked loan origination processes and used for wider purposes including screening and evaluating lending opportunities, assessing the viability of transition plans and structuring green and sustainability-linked loans. Specific examples of market practice include green loan origination thresholds based on the technical screening criteria, using the Taxonomy Regulation to consider baselines or exclusion criteria and structuring Taxonomy-aligned green loan incentives. Credit institutions are also using the Taxonomy Regulation more widely for the purposes of engaging with, supporting and attracting clients, monitoring progress on sustainability targets and analysing whether transactions should count as "sustainable" or "green" for internal loan books, the Green Asset Ratio and distribution purposes.

ESG consultants and auditors

ESG Consultants and Auditors have noticed a shift from organisations making general sustainability claims to more specific, measurable and financially defined information, data and key performance indicators which are Taxonomy-aligned. ESG consultants and auditors are also being used earlier in an investment or finance process by companies in order to better prepare relevant data in an auditable manner and ensure that relevant processes are Taxonomy-aligned.

SMEs

SMEs continue to face challenges in accessing sustainable loan products despite recognition of the important role that SMEs play in achieving EU sustainability goals. These challenges are well documented and include the limited resources and skills available to SMEs which contributes to the lack of usable reported sustainability-related data by SMEs. Since much of the mandatory disclosure regime does not directly impact SMEs, the report highlights the need for banks to proactively support and engage with SMEs in order to raise awareness and understanding of sustainable loan structures and the benefits that SMEs can access through them.

Corporates

The need for Taxonomy-related disclosure and reporting has increased awareness of the key sustainability and transitional improvements relevant to or required of a business or sector. Corporates for example, are using Taxonomy-aligned key performance indicators for strategic transition planning, for the purposes of setting relevant sustainability targets and to improve comparability with peers and industry benchmarks. This has led to a greater understanding of how information and data gathered for regulatory compliance can be used and presented in order to improve access to private capital, lending and investment.

GRI publishes updated Biodiversity Standard

GRI 101 is intended to reflect internationally agreed best practice and also align with new developments to ESG standards and law and regulation including international goals such as the Kunming-Montreal Global Biodiversity Framework, the Taskforce on Nature-related Financial Disclosures disclosure and ESRS E4 Biodiversity and ecosystems.

Thresholds

The previous threshold of 50% in sustainable investments for use of sustainability-related words in funds' names will not be retained. Instead the fund should:

- apply the 80% minimum proportion of investments used to meet the sustainability characteristics or objectives;
- apply the Paris-aligned Benchmark exclusions; and
- invest meaningfully in sustainable investments defined in Article 2(17) SFDR, reflecting the expectation investors may have based on the fund's name.

Adaptation to Transition

- In order to avoid penalising funds with a transitional strategy or which use terms that are not environmental, ESMA suggests introducing a new category to which Climate Transition Benchmark exclusions (see Article 12(1)(a)-(c) of Commission Delegated Regulation (EU) 2020/1818) (**CTB**)) should apply as well as the above 80% threshold;
- funds with social or governance terms in their names may find their investment universe restricted by fossil fuel exclusions and therefore, where terms are combined, future guidelines will apply cumulatively; and
- where environmental terms and transition terms are used in a funds name, the CTB exclusions should apply – although this would not apply for "sustainable" terms which give an impression of sustainability irrespective of any other term used in the fund name.

Impact and Transition Terms

The use of "transition" or "impact"-related terms in fund names will require that investments under the minimum proportion of investments are made with the intention to generate positive, measurable social or environmental impact alongside a financial return or are on a clear and measurable path to social or environmental transition.

ESRS enter into force

In December 2023, a first set of sector agnostic ESRS was published in the Official Journal of the EU. The ESRS are intended to apply to all companies falling under the scope of Corporate Sustainability Reporting Directive (CSRD) regardless of the sector that they apply to.

An LMA summary regulatory alert relating to this can be accessed here.

European Financial Reporting Advisory Group (EFRAG) publishes ESRS Implementation Guidance (ESRS IG)

In December 2023, EFRAG released the first three draft ESRS Implementation Guidance (ESRS IG) documents to provide implementation support for organisations preparing their first statements according to ESRS. The following guidance has been made available:

- Draft EFRAG IG 1 - Materiality assessment implementation guidance: describes the reporting requirements on the materiality assessment and includes FAQs on the double materiality assessment and interoperability with other standards;
- Draft EFRAG IG 2 Value chain implementation guidance: describes the reporting requirements on the value chain within the materiality statement (setting out, relevant metrics and targets), considers the reporting boundary of the group for sustainability reporting and includes FAQs to provide further information and includes a 'value chain map' summarising certain value chain implications; and
- Draft EFRAG IG 3 Detailed ESRS datapoints implementation guidance: contains detailed ESRS data points as an excel spreadsheet along with an explanatory note. EFRAG indicates that IG 3 can be used to perform a data gap analysis.

The ESRS IG documents are non-authoritative and are intended to support ESRS. In the event of any inconsistency, the ESRS shall prevail.

ESRS: Two year delay to sector-specific and general standards for non-EU companies

Earlier this year, European Parliament and Council negotiators agreed to a two-year delay with respect to the adoption of sector-specific sustainability reporting standards and those for non-EU companies. The delay is aimed at reducing the administrative burden on companies whilst also allowing European Financial Reporting Advisory Group (EFRAG) additional time to develop the relevant European Sustainability Reporting Standards (ESRS).

The two-year delay for these specific standards affects the extent of reporting for relevant companies but does not affect the existing staggered reporting timelines under Corporate Sustainability Reporting Directive (CSRD). Companies are still required to report on time against the sector-agnostic ESRS (see above).

Sector-specific reporting by companies is considered an important source of information for investors, particularly in the context of “high-risk” sectors such as oil, gas, and mining. The EC will therefore publish sector-specific sustainability reporting standards in eight areas as soon as they are available and before the deadline of June 2026. It is unclear at present which eight sectors the EC will prioritise.

The agreement on the delay needs to be formally adopted by the Council and the European Parliament before it can enter into force (see EU press release).

CSRD and ESRS: Background

On 5 January 2023, the Corporate Sustainability Reporting Directive (**CSRD**) entered into force and from 1 January 2024, CSRD and the European Sustainability Reporting Standards (**ESRS**) will apply to the first group of companies (large EU listed companies, public interest entities and groups as well as large non-EU issuers and groups) for reports published in 2025.

The European Financial Reporting Advisory Group (**EFRAG**) is developing the ESRS, the reporting standards which set out the information that companies will need to disclose and report on in accordance with CSRD. Below, we summarise the most significant developments relating to CSRD and ESRS.