Environmental and social risk management guidance for funds and fund managers

European Bank
for Reconstruction and Development

Introduction

Funds are considered financial intermediaries (FIs) for the purposes of the EBRD's Environmental and Social Policy (ESP).[1] This note provides specific guidance to funds and fund managers on the environmental and social (E&S) conditions required for compliance with the applicable Performance Requirements (PRs 2, 4 and 9) of the EBRD's Environmental and Social Policy.[2] The guidance note applies to all funds, irrespective of their investment strategy or legal form.

The ESP, the PRs and this guidance note focus solely on E&S issues. The EBRD acknowledges that established best practice in the investment industry spans environmental, social and corporate governance, giving rise to the widely used term "ESG".

General principles

The fund documents[3] must include provisions that address the core requirements of PR9 by establishing:

- a list of activities in which the fund cannot invest (in line with the EBRD Exclusion List in the ESP)
- the requirement to comply with national E&S standards, the use of environmental and social action plans (ESAPs), where appropriate and, in the case of Category A investments,[4] alignment with EBRD PRs 1-8 and 10.
- arrangements to promptly notify the EBRD and other investors in the event of significant adverse E&S incidents, material events or E&S-related complaints
- annual reporting to the EBRD on the E&S quality of the portfolio
- a formal environmental and social management system (ESMS) (integrated as appropriate into core policies and standard operating procedures) in respect of the above, including the definition of E&S-related roles and responsibilities within the fund management team; the ESMS needs to provide relevant input to the investment committee and fund board (or equivalents), as well as the adoption of appropriate E&S policies and procedures consistent with the ESP and PR9
- any additional E&S-related commitments or disclosures required as a result of applicable regulations, such as the European Union (EU) Sustainable Finance Disclosures Regulation (SFDR)[5] (see the final section of this guidance note).

The documents that establish and operationalise the employment-related duties and responsibilities of the general partner, fund management company and/or advisor should also make reference to labour and working conditions and health, safety and security in the context of EBRD PR2 and PR4 (see the final section of this guidance note).

Strategy-specific requirements and recommendations

Within the general framework summarised above, each fund's ESMS must be tailored to its specific investment strategy, as well as being commensurate with the level of E&S risk of the anticipated investment portfolio, taking into account the guidance provided below.

E&S as a driver of shareholder value

Although PR9 deals with avoiding E&S risks that can be material to those negatively impacted by a fund's investment decisions, effective E&S stewardship by actively managed funds is also important in relation to the protection and enhancement of shareholder value. Funds are, therefore, encouraged to seek out and act on value-added E&S-related opportunities, as well as risks.

Climate risk

Climate risk management is an important emerging issue for the financial performance of all types of fund. Identification and the assessment of climate-related financial risks as part of investment decisions aim to benefit fund returns and can help identify promising new companies that are focused on greenhouse gas (GHG) emission reduction technology (mitigation) or innovative ways to adapt to changing climatic conditions (adaptation). Those companies that benefit from the transition to a low-carbon economy or from adaptation to the changing climate may gain significant market share in the coming years. In addition, climate risk management during the portfolio company's holding period aims to help achieve expected returns from the fund's overall activities.

[1] See EBRD (2019). [2] Ibid. [3] Limited partnership agreement (LPA), shareholder agreement, private placement memorandum or side letter.
[4] Appendix 2 of the ESP (2019). [5] See European Union (2023).

The integration of climate risk into investment due diligence gives fund managers a more complete understanding of the future financial performance and exit value of potential investee companies. By incorporating the financial impacts of expected changes to the physical climate and the impacts of emissions costs and other policies related to the low-carbon transition, actual and expected returns should align more closely. As climate risks (both physical and transition) can have material impacts on revenue, operating expenditure (opex) and capital expenditure (capex), which may erode financial performance over time, it is in both fund managers' and the EBRD's financial interest that these additional risks be incorporated into fund due diligence and company valuation.

International Financial Reporting Standards (IFRS) S2 reporting standards,[6] which build on the standards of the Task Force on Climate-related Financial Disclosures (TCFD),[7] provide a useful framework for integrating these risks into overall investment decision-making, whether they be used to disclose such risks or not. All else being equal, as the materiality of these risks increases, those funds that incorporate these risks are less likely to see an unanticipated divergence from expected financial performance and exit valuations. The EBRD recommends integrating climate-related financial risk into due diligence and fund management, as it is in the financial interest of all fund investors.

Human rights

Funds making active equity investments should also recognise that their role (especially when exercising their right to nominate directors to the board of the investee company to influence its strategy and business decisions) may put them in a position (albeit indirect) to cause or contribute to adverse E&S impacts. This, in turn, may raise the prospect of third parties holding the fund at least partly responsible for remedying such impacts (for example, in the event of civil litigation), particularly in relation to human rights where the United Nations Guiding Principles on Business and Human Rights (UNGPs)[8] apply.

Alignment with industry good practice frameworks

All funds are encouraged to align their policies and procedures on E&S matters with the United Nations Principles for Responsible Investment (PRI)[9] and with other, more specific, E&S good-practice frameworks relevant to their particular market, in addition to the EBRD's Environmental and Social Policy and PRs. For example:

- Private equity and venture capital funds are encouraged to consider complying with relevant PRI guidance for those asset classes and with complementary principles and codes issued by other industry bodies, such as Invest Europe's ESG Reporting Guidelines[10] and similar guidance published by the Global Private Capital Association (GPCA) and the Institutional Limited Partners Association (ILPA) (see the *Useful links* page in this guidance note).
- Funds (especially infrastructure funds) whose investment strategies include project finance or large project-related corporate loans may wish to align their ESMSs for such types of asset with the Equator Principles[11] and the PRI's infrastructure fund guidance (see the *Useful links* section of this report), in addition to the EBRD's Environmental and Social Policy and PRs. The EBRD expects such funds to be able to demonstrate in-house E&S expertise and capacity, as well as access to suitable external consultants.
- Funds (especially private credit funds) whose investment strategies include or focus solely on loans and bonds (including labelled bonds, such as green bonds) must ensure that their ESMS aligns with the EBRD's own approach to this asset class. See the *Bonds* guidance note in this series for further information on the EBRD's E&S requirements for bonds. Additional guidance on corporate, sub-sovereign and sovereign bonds can be provided on request.
- Funds whose strategies include or specialise in green loans, sustainability loans or social loans are encouraged to align their ESMS with the Green Loan Principles,[12] Sustainability-Linked Loan Principles[13] and/or Social Loan Principles[14] adopted by the Loan Market Association and Loan Syndications and Trading Association, as well the relevant international capital markets association (ICMA) principles.

[6] See IFRS (2023a; 2023b). [7] See TCFD (2017). [8] See OHCHR (2011). [9] See PRI Association (n.d.). [10] See Invest Europe (n.d.).
[11] See Equator Principles (2020). [12] See LSTA (2023a). [13] See LSTA (2023b). [14] See (LSTA) (2023c).

Sector-specific considerations

Funds whose investment strategies include financing for banks and non-bank financial institutions through credit lines, subordinated loans or similar, as well as through equity, must ensure that their ESMS is consistent with the EBRD's own requirements for FIs. In other words, the fund must require such FIs to comply with PR9 (either explicitly or by specifying the same types of E&S requirement).

Funds (especially private equity and venture capital funds) that focus on highly specialised investment strategies (especially in sectors such as healthcare, fintech, artificial intelligence, blockchain, agritech and cleantech) are encouraged to demonstrate their alignment with emerging sector-specific E&S best practices and to continue informing themselves on key future developments in this regard.

EU sustainable finance framework

Many of the funds in which the EBRD invests are regulated in the EU under the Alternative Investment Fund Managers Directive[15] or the Directive on Undertakings for Collective Investment in Transferable Securities,[16] so may be subject to ESG-related regulations under the EU's sustainable finance framework, including the EU Taxonomy,[17] SFDR and Corporate Sustainability Reporting Directive.[18]

Authoritative information and guidance in this regard is available to fund managers from the European Securities and Markets Authority, the ICMA principles, the EU Platform for Sustainable Finance, the European Financial Reporting Advisory Group and many other sources (see the *Useful links* page of this guidance note).

The EBRD wishes to maximise the opportunities that SFDR and the EU Taxonomy present for efficient interoperability with the Bank's own E&S requirements, particularly in relation to the equivalency of E&S-related reporting. To minimise the reporting burden on general partners, funds that make annual ESG/sustainability disclosures under Article 8 or Article 9 of SFDR will not normally need to provide the EBRD with a separate annual E&S report, provided that the general partners' regular (non-SFDR) reports to limited partners also include appropriate commentary and updates on any critical ESG developments or incidents at the fund's investee companies. Article 6 funds (including those whose SFDR disclosures state that sustainability risks are not deemed relevant) will still need to prepare an annual E&S report in line with the E&S reporting requirements agreed with the EBRD (see guidance on *Reporting to the EBRD*).

The fund management company as employer

The operating entity responsible for employing the fund's investment professionals and support staff must ensure that it complies with EBRD PR2 (on labour and working conditions) and PR4 (on health, safety and security),[19] as well as national employment law and regulations on health and safety at work. See the EBRD's *PR2 Guidance Note*[20] and *PR4 Guidance Note*[21] for further information.

Useful links

- Equator Principles
- EU Platform on Sustainable Finance
- European Financial Reporting Advisory Group: Sustainability Reporting Standards
- European Securities and Markets Authority: Sustainable Finance
- Global Private Capital Association: various ESG resources
- IISB and TCFD
- Institutional Limited Partners Association: ESG resources
- International Capital Markets Authority: Sustainable Finance
- Invest Europe: Sustainable Finance
- Loan Market Association: sustainable lending
- Principles for Responsible Investment: infrastructure guidance and resources
- Principles for Responsible Investment: private equity guidance and resources
- SFDR – 1 and 2 (2019)
- SFDR – additional provisions (2022)
- SFDR templates:
  - SFDR 1
  - Article 8 fund: Precontractual – Annual reporting
  - Article 9 fund: Precontractual – Annual reporting

[15] See European Union (2011). [16] See European Union (2009). [17] See European Commission (n.d.). [18] See European Union (2022).
[19] See EBRD (2019). [20] See EBRD (2023b). [21] See EBRD (2023c).

References

EBRD (2019), *Environmental and Social Policy*, London. Available at: https://www.ebrd.com/news/publications/policies/environmental-and-social-policy-esp.html.

EBRD (2023a), *Guidance note – EBRD Performance Requirement 9: Financial intermediaries*, London. Available at: https://www.ebrd.com/who-we-are/our-values/environmental-and-social-policy/implementation.html.

EBRD (2023b), *Guidance note – EBRD Performance Requirement 2: Labour and Working Conditions*, London. Available at: https://www.ebrd.com/who-we-are/our-values/environmental-and-social-policy/implementation.html.

EBRD (2023c), *Guidance note – EBRD Performance Requirement 4: Health, safety and security*, London. Available at: https://www.ebrd.com/who-we-are/our-values/environmental-and-social-policy/implementation.html.

Equator Principles Association (2020), *Equator Principles* (EP4), London. Available at: https://equator-principles.com/.

European Commission (n.d.), EU Taxonomy Navigator, Brussels. Available at: https://ec.europa.eu/sustainable-finance-taxonomy/home.

European Union (2009), *Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast)*, Brussels. Available at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32009L0065.

European Union (2011), *Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010*, Brussels. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32011L0061.

European Union (2022), *Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting*, Brussels. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464.

European Union (2023), *Sustainable Finance Disclosures Regulation (SFDR)*, Brussels. Available at: https://finance.ec.europa.eu/regulation-and-supervision/financial-services-legislation/implementing-and-delegated-acts/sustainable-finance-disclosures-regulation_en.

IFRS (2023a), *IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information*, London. Available at: https://www.ifrs.org/issued-standards/ifrs-sustainability-standards-navigator/ifrs-s1-general-requirements/.

IFRS (2023b), *IFRS S2 Climate-related Disclosures*, London. Available at: https://www.ifrs.org/issued-standards/ifrs-sustainability-standards-navigator/ifrs-s2-climate-related-disclosures/.

Invest Europe (n.d.), Invest Europe ESG Reporting Guidelines, Brussels and London. Available at: https://www.investeurope.eu/invest-europe-esg-reporting-guidelines/#tab-acknowledgements.

LSTA (2023a), *Green Loan Principles*, New York. Available at: https://www.lsta.org/content/green-loan-principles/.

LSTA (2023b), *Sustainability-Linked Loan Principles*, New York. Available at: https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/.

LSTA (2023c), *Social Loan Principles*, New York. Available at: https://www.lsta.org/content/social-loan-principles-slp/.

OHCHR (2011), *Guiding Principles on Business and Human Rights*, New York and Geneva. Available at: https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf.

PRI Association (n.d.), Principles for Responsible Investment, London. Available at: https://www.unpri.org/.

TCFD (2017), *Recommendations of the Task Force on Climate-related Financial Disclosures*, Basel, Switzerland. Available at: https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf.

June 2024

Five Bank Street
London E14 4BG
United Kingdom

www.ebrd.com

Disclaimer

This document contains references to good practices and should be interpreted bearing in mind the Environmental and Social Policy adopted by the EBRD; it is not a compliance document. It does not alter or amend EBRD policies and does not create any new or additional obligations for any person or entity. In case of any inconsistency or conflict between this document and the Environmental and Social Policy adopted by the EBRD as amended from time to time, such policy shall prevail. Questions of interpretation shall be addressed solely in respect of the Environmental and Social Policy.

The information and opinions within this document are for information purposes only. No representation, warranty or undertaking expressed or implied is made in respect of any information contained herein or the completeness, accuracy, or currency of the content herein. The EBRD does not assume responsibility or liability with respect to the use of or failure to use or reliance on any information, methods, processes, conclusions, or judgments contained herein, and expressly disclaims any responsibility or liability for any loss, cost, or other damages arising from or relating to the use of or reliance on this document. In making this document available, the EBRD is not suggesting or rendering legal or other professional services for any person or entity. Professional advice of qualified and experienced persons should be sought before acting (or refraining from acting) in accordance with the guidance herein.

This document does not constitute or imply a waiver, renunciation or other modification, either express or implied, of any of the privileges, immunities and exemptions granted to the EBRD under the Agreement Establishing the European Bank for Reconstruction and Development, international convention or any applicable law. Certain parts of this document may link to external internet sites and other external internet sites may link to this publication. The EBRD does not accept responsibility for any of the content on these external internet sites.