How does private debt lend itself to sustainable impact?

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INTRODUCTION

Private debt is not just a financing tool – it can be a strategic lever for sustainable transformation. This article explores the sustainability benefits derived from private debt investments, and the mechanisms through which they are achieved.

It will (1) explore the current investment terrain, (2) investigate the limitations of short-termism in public markets, and (3) argue that sustainability-linked loans (SLLs) can bolster big moves for individual investments, whilst highlighting their risks. Taking this one step further, it will (4) evaluate the impact of sustainability-linked carry for the investment manager, and (5) underscore the importance of market collaboration to drive systems-level sustainable impact.

Private debt takes many forms; this article will focus on direct lending to create impact. Direct lending makes over 60% of capital raised in 2024 and 37% of the global private credit AUM [Pitchbook,2024].[1] Therefore, direct lending is a relevant asset class and the focus of this discussion.

FROM PUBLIC TO PRIVATE, INVESTORS WANT RETURNS AND IMPACT

Recent investment trends have been favourable for direct lenders who aim to achieve impact through accelerating the sustainable growth of private companies. Though the 2025 political climate has stalled confidence in ESG labels, with words like "green hushing" entering the financial vocabulary, impact investing continued to gain traction and differentiate sustainability-focused General Partners (GPs).

TREND 1: PRIVATE MARKETS ARE ECLIPSING THEIR PUBLIC COUNTERPARTS

Over the last 20 years, the number of publicly-listed companies fell in the US and Europe, whilst private markets boomed. In Europe, the total number of enterprises rose by 53.9% between 2013 and 2023 [Eurostat, 2025],[2] whilst the total number of publicly-listed companies fell; for example, companies listed on the London stock exchange fell by 25% in the same period [London Stock Exchange, 2025].[3]

TREND 2: INVESTOR APPETITE FOR IMPACT IS ACCELERATING

Financial markets witnessed the rise of impact investing, despite slowing trends in 2025. The Global Impact Investing Network (GIIN) estimated that there was USD1.6 trillion AUM in impact assets in 2024, of which 43% is allocated to private markets [GIIN, 2024].[4] Institutional investors have embraced private markets, more willing to add illiquidity risk in search of enhanced risk returns and impact. GPs have thus more innovatively embedded sustainability into investment strategies, particularly for private debt [WEF, 2023],[5] differentiating themselves through impact.

TREND 3: GLOBAL REGULATORS ARE WARNING ABOUT THE POTENTIAL RISKS OF NON-BANK LENDING

Non-bank lenders are a material financial market players, holding around half of the world's financial assets; the IMF Global Financial Stability Report stress tests highlighted the quick transmissibility of nonbank distress into the main banking system [IMF 2025].[6] Prudent risk management and transparency from GPs is therefore under high scrutiny from LPs.

THE (DIS)-ADVANTAGES OF KEEPING THINGS PRIVATE

IT'S A MARATHON, NOT A QUARTERLY SPRINT

Longer-term value creation fostered in private companies complements the tempo of impact investing. Davies et al (2014)[7] highlight the costs of short-termism on the financial system, demonstrating how investor myopia leads to manager prioritisation of near-term cashflows and dividends. For sustainable investors, long-term thinking is more compatible with sustainability time-horizons.

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Schot et al (2023) view short-termism as a barrier to realising the transformational investments required for tackling climate change in core sectors, like energy, mobility, water, healthcare and food.[8] Shareholder pressure on public companies to deliver short-term profit can limit preparations for net-zero transitions and disincentivise physical adaptation investments to protect against changing climates.

PD funds typically assume a 5–10-year investment time horizon; reflecting the loan tenor. This medium-term runway supports sustainable decision-making and technological development, equipping portfolio companies with tools to navigate challenges of scale, and to withstand market forces, by instilling commitments to sustainability priorities at loan maturity. This intervention occurs at an inflexion point, when foundations are laid for long-run growth.

DRAWBACKS AND LIMITATIONS OF PRIVATE COMPANIES VERSUS PUBLIC

- Private debt is not tradable in the public market, therefore no Mark-to-Market valuation is available. The added complexity, stemming from lower data availability and comparability, can make it difficult to model risk & return, including ESG risks and opportunities. This risk is rewarded by a higher yield – on average 320bps during Q4'18 – Q4'24, according to Lincoln International (Lincoln International, 2024).[9]
- Private companies are often smaller, facing challenges on data collection and sustainability reporting, and not benefitting from the same economies of scale as their public counterparts with a dedicated sustainability department. A small, private company may be reliant upon a single sustainability officer or CFO/CEO, limiting the breadth of ESG data for investors.
- Similarly, private companies' supply chains are commonly constituted of smaller companies, which may not have complete sustainability reporting. Value chain emissions measurements can be difficult and rely upon estimates. However, developments in AI and reporting software have improved data collection and sharing, enhancing transparency for investors.

ENCOURAGING BOLD, IMPACTFUL, MOVES THROUGH SLLS

SLLs are a type of private debt instrument with dependent characteristics attached to pre-agreed sustainability objectives. This can be a way to have "investor contribution" when it comes to impact, defined as the additionality of an investor in enabling enterprises to have impact [IMP 2019].

The main lever for asserting sustainable impact is the incentive and penalty that is applied in the loan terms (the interest rate adjustment); determined by whether the sustainability performance targets (SPTs) are reached. This is a direct tool for lenders to incentivise sustainable advancement, while structurally embedding their own investor contribution into the loan.

Figure 1
Example Margin Adjustments

SPTs met	Margin adjustment
0	10bps
1	0bps
2	-10bps
3	-20bps

Taking the example of a mid-size manufacturing company, a direct lender might set a SBTi-validated GHG emissions reduction target, in line with a net zero pathway, and a waste reduction target to promote circularity. It might also set a target for the percentage of revenue linked to sustainable products.

If the company then scales up, it is incentivised to do so within the target boundaries; adhering to a net zero transition pathway, considering circular practices, and scaling the production of sustainable goods.

Figure 2
Example Terms of Annual Adjustment

SPT	Annual evaluation	Financial impact
1. SBTi Carbon reduction targets	Fail	
2. Waste reduction target	Pass	**-10bps**
3. Revenue alignment from impactful products	Pass	

WHAT IS THE DIFFERENCE BETWEEN AN SLL AND AN SLB?

SLLs and sustainability-linked bonds (SLBs) are more similar than they are different. In contrast to green, social and sustainability (GSS) bonds, proceeds of SLLs are not necessarily dedicated to sustainable projects. Instead, the sustainability component lies within the selected Key Performance Indicator (KPIs) and SPTs, which are subject to the same guidance as for SLBs.

Where they differ is in who sets the KPIs. Usually, SLBs are accompanied by a SLB framework, where the company has set out its selected KPIs and SPTs. Investors can then decide whether they think these are robust enough when making their investment decisions.

For direct lending, SLL KPIs and SPTs are set together by the lender, borrower and, if applicable, the private equity sponsor. In contrast to an SLB which has many investors, there is only one or a limited number of lender(s). This means the lender is directly involved and has more agency to steer the sustainability trajectory in an impactful direction.

Figure 3
Differences Between SLLs, SLBs and GSS Bonds

SLL	SLB	GSS
Private loan	Public bond	Public bond
Proceeds for general use	Proceeds for general use	Sustainable use of proceeds
KPIs and SPTs, set by lender	KPIs and SPTs, set by borrower	No KPIs or SPTs
Less transparent	Transparent reporting	Transparent reporting
LMA SLLPs	ICMA SLBPs	ICMA GBPs/SBPs

Source: Colesco Capital. (SLL = Sustainability-Linked Loan, SLB = Sustainability-Linked Bond, GSS = Green, Social, Sustainability bonds)

THE IDEAL SLL CANDIDATE

SLLs can be an impactful instrument to assert sustainable impact. Though declining in absolute terms since 2021, SLLs still represent the majority of global sustainable loan issuances (See Table 1), versus green or other (social, sustainability, transition) loans.

Table 1
Breakdown of Global Sustainable Loan Issuances (USD$)

Year	SLL	%	Green	%	Other*	%	Total
2015	0	0	29.3	100%	0	0%	29.3
2016	2.3	6%	38.1	94%	0	0%	40.4
2017	5.0	10%	46.5	90%	0.3	1%	51.8
2018	48.6	44%	63.1	56%	0	0%	111.7
2019	144.1	59%	97.9	40%	2.6	1%	244.6
2020	141	60%	92.7	40%	0.5	0%	234.2
2021	528.7	81%	117.3	18%	4.6	1%	650.6
2022	472.7	76%	138.2	22%	14	2%	624.9
2023	243.7	59%	157.2	38%	13.8	3%	414.7
2024	294.4	56%	210.3	40%	19.4	4%	524.1
2025F	270	56%	190	39%	22.3	5%	482.3

Source: Data from ING 'Global sustainable finance 2025: mixed results highlight regional differences', 16 September 2025.
* Other includes Sustainable, Social and Transition loans.

Private companies can be perfect candidates for SLLs, particularly those with transformative products and services that are needed for the achievement of the UN SDGs. PD funds can propel ambitious portfolio companies, when there is management appetite for strategic refocus. SLLs provide an additional discount to financing, through rewarding sustainability improvements.

Many mid-cap companies specifically are in the growth stage of their business lifecycle; likely to be considering big investments. Through SLLs, direct lenders capitalise on mid-market tendencies for strategic retuning via carefully-tailored sustainability KPIs and specific, relevant, and material SPTs.

Notably, capital- and emissions-intensive manufacturing companies (of which around 50% are mid-caps) invest at over double the rate of the service sector, becoming 'hidden champions' for investors [Simon, 2025].[10] Investors can influence decision-making at an opportune moment, before important capital investments are set in stone, ensuring e.g. consistency with a net-zero pathway.

GUIDANCE FOR MATURITY: THE SUSTAINABILITY LINKED LOAN PRINCIPLES (SLLPS)

Lenders can look to the SLLPs for guidance on how to robustly structure SLLs, referring to its five core components:

Figure 4
The Components of the SLLPs

Component	Requirements/recommendations
1. Selection of KPIs "The credibility of the SLL … will rest on the selection of the KPIs"	• Relevant, core and material to strategy • Consistent with borrower's sustainability strategy • Measurable / quantifiable • Where feasible, externally verifiable
2. Calibration of SPTs "The expression of the level of ambition"	• Annual SPT per KPI for life of loan • Representing material improvement, beyond Business As Usual • If possible, benchmarked (3Y track record / peers / science) • Aligned to borrower's sustainability strategy • Predefined timeline, before origination of the loan
3. Loan Characteristics	• Interest rate (margin) variation dependent on achieving SPTs, providing material financial incentives
4. Reporting	• At least annually, or when there is an adjustment to the SLL's characteristics, borrower should provide: – Up-to-date KPIs and performance against SPTs – (Ideally) reported in sustainability/ annual report
5. Verification	Independent/external verification of KPI performance vs SPTs

Source: Sustainability Linked Loan Principles. Loan Markets Authority (March, 2025).

Refined in March 2025, these principles detail criteria for the selection of KPIs and SPTs, underscoring the importance of contextualising within the borrower's sustainability strategy and geography. The update also includes the ICMA Sustainability-Linked Bonds KPI Registry as a recommended resource for KPI examples for SLLs, providing a credible centralised resource for externally 'accepted' metrics.

After an initial critical reception regarding the ambition-level of SLLs, the establishment of the SLLPs helped the maturity of the SLL market. The FCA's recent review of SLLs notes improved relevance of KPIs, alongside more material, strategically-significant and focused SPTs for the borrower [FCA, 2025].[11]

The review also flagged persisting barriers, particularly for SMEs, including costs of reporting frameworks (including mandatory external assurance). For lenders, the FCA highlights the benefits of robust systems for KPI monitoring, pre- and post-transaction.

If a company has not yet established a sustainability strategy – more common amongst SMEs and mid-market participants – there can be less scope for lenders to blend the loan's SPTs into the pre-existing company fabric and increased information asymmetry with higher potential for less relevant KPIs. These risks can be mitigated by collaborative engagement between the lender and borrower, and can even present greater scope for impact if also introducing – as needed first step – a sustainability strategy with relevant strategic sustainability measures.

If KPIs are successfully aligned with the company's strategy, then the achievement of the SPTs can arguably future-proof the business and reduce business risks, improving the risk/return profile. This is especially important in illiquid markets, with higher investment risks.

Whilst the margin variation can result in a slightly reduced absolute return for investors (if the companies are successful), it adds an additional layer of impact to an investment that is not just from the activities of the underlying company, but also in the investor contribution from shaping sustainable outcomes. If the companies miss the SPTs, then the investor is compensated with a slightly higher return. All-in-all the return is not materially different from the non-SLL equivalent.

SUSTAINABILITY-LINKED CARRY; LENDERS TASTING THEIR OWN MEDICINE

Incentive alignment mechanisms are not limited to portfolio companies. Carried interest, or carry, is the share of the profits above the hurdle rate of the PD fund that GPs retain. Sustainability-linked carry links a proportion of financial performance to specific sustainability targets. This can be beneficial for LPs and the fund, strengthening GP sustainability capacities, fund reputation, diversification, investor base, and returns [ISFC, 2025].[12]

As with SLLs, KPI selection and target setting is crucial for this mechanism to achieve meaningful impact. The ISFC observed that, most commonly, 2-4 portfolio-level KPIs are selected, including a Scope 1-2 CO2 emission reduction target and a thematic social metric. They conclude that the ESG-linked carry mechanism "creates a novel incentive for GPs to pay closer attention to the impact of their investments", contingent on robust KPI selection, measurement and verification.

Figure 5
Benefits and Limitations to Sustainability-Linked Carry

Benefits	Limitations
• **Alignment of financial incentives** – Incentivises GPs to deliver financial returns **and** achieve measurable impacts. • **Enhances accountability and transparency** – Ex-ante definition of a fund's impact goals and subsequent reporting gives LPs clearer visibility on impact outcomes. • **Catalyst for market evolution** – LPs push the industry towards more standardised and rigorous impact measurement, with systemic benefits. • **Credibility** – Attracts committed managers, and reinforces sustainability commitments	• **Resource diversion** – Could divert time, resources and attention of GPs away from short-run financial return • **Additional costs** – Can require additional reporting, expertise, staffing capacity and regulatory compliance • **Complexity** – Difficult to set high quality and verifiable KPIs and targets which work for a diversified portfolio • **Talent** – If KPIs are poorly chosen, or too ambitious, GPs may be penalised despite strong financial returns, which could discourage top-tier managers

Source: Colesco

ENGAGEMENT FOR IMPACT

I'D LIKE TO SPEAK TO MANAGEMENT PLEASE

Direct lenders gain face-to-face access to company management. Private markets on average have smaller senior management teams, with a median of seven directors versus an average of 10.7 in S&P 500 companies [Tonello, 2023].[13] This lends itself to more nimble decision-making, and greater opportunities for engagement to encourage meaningful sustainability integration.

In private markets, directors are also more likely to be actively engaged. A McKinsey survey found that PE-backed company directors spent 55% more time engaging with shareholders versus directors of public companies, and 41% more time with management.[14] Hands-on management approaches can encourage dispersion of sustainability throughout the business, both top-down and bottom-up.

SPONSOR ENGAGEMENT AND PARTNERSHIP

PD and private equity (PE) can have a symbiotic relationship when it comes to propelling sustainable impact. According to the Deloitte Private Debt Deal Tracker (Spring 2025), only 93 out of 855 PD deals did not involve a private equity sponsor [Deloitte, 2025].[15] This close relationship presents another influence stream for lenders, unlocking synergies across portfolios (see Table 2).

Table 2
Benefits of engagement between PD and PE houses

For Portfolio Companies	For GPs	For LPs
• Aligned targets setting, amplified strategic sustainability improvements and avoids mixed messages • Streamlined sustainability reporting, improving accuracy and completeness of sustainability data • Potentially reducing reporting loads through aligned data requests	• Ongoing engagements informs sustainability strategies for PE and PD houses, raising the bar for impact • PE houses can be a source of deal origination for thematically-aligned PD providers, assisting with impactful capital deployment	• Possibility to generate more impact from investments • Alignment in impact reporting outcomes and standardisation of impact data

SYSTEMS-LEVEL IMPACT; PORTFOLIOS ARE GREATER THAN THE SUM OF THEIR PARTS

With the transition requiring economy-wide synergies, achieving sustainable impact requires investments to alter the "rules" of the system and have complementary impacts for connected goods and services. Schot et al (2023) believe that viewing portfolios as ecosystems, rather than collections of individual companies, helps to strengthen impact.[16] Similarly, Goyeneche et al (2022) emphasise the interlinkages of the UN SDGs, and the need to view them as a narrative of transformational system development, rather than individual goals.[17]

As investors, it is important to deeply consider the sustainability rationale behind a Theory of Change,[18] and evaluate impact at a fund level, ensuring it is sufficiently ambitious and consistent with the fund's overall impact goals. Bold moves don't just need to come from the portfolio companies, they can also be championed by forward-thinking investors.

MORE TO DO; LENDING FOR A HAPPY ENDING

How can PD investors raise the bar? One lever could be in setting stricter targets, when structuring SLLs. Another could be coordinating the KPI-selection process across the investment portfolio with a holistic systems-level impact approach. Further, engagement with the borrower and sponsor (where relevant), and wider stakeholders, can connect the dots across the financing system, to coordinate approaches for even greater impact.

Private debt cannot by itself solve the climate crisis and must work with the entire financial ecosystem to create the systems change which is needed for a more sustainable world. Those who share this ambition must work together to connect capital with purpose.

Notes

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18 According to the GIIN, a Theory of Change is a framework that describes a sequence of cause-and-effect actions or occurrences by which organizational and financial resources are hypothesized to be converted into the desired social and environmental results.