GETTING STARTED

If the fund manager does not already have an ESG management system, they should consider how management of ESG issues can be integrated into their fund, or funds', operations. The guidance below is intended to help fund managers to start designing an ESG management system. For detailed guidance see Fund Environmental and Social Management System and Fund Governance and Business Integrity Management System.

Who should lead the process of designing an ESG management system?

Experience has shown that it is best to appoint at least one Senior Partner to champion and oversee the ESG management system (ESGMS), or systems, even if it is to be implemented by other team members. An ESGMS will only be effective if it is well implemented. This requires commitment from top management. It is therefore important to ensure that Senior Partners are involved from the beginning to provide the high-level commitment and strong internal support that will be necessary to ensure that: (i) ESG is appropriately integrated into the overall fund's investment strategy and operations; (ii) that ESG is taken seriously at all levels of the organisation; and (iii) any resourcing requirements are addressed as they arise.

Reviewing context and needs

Management systems need to at least cover environmental and social (E&S), corporate governance and business integrity factors. It is up to each fund to decide whether and how to integrate these systems in an ESGMS. Most will find it convenient to have two related, but separate, sets of management system: (i) an environmental and social management system (ESMS) and (ii) a governance and business integrity management system (GBIMS). When the CDC ESG Toolkit for Fund Managers refers to an ESGMS, it includes both ESMS and GBIMS regardless of whether these are two separate management systems or one integrated management system.

A good ESGMS should be tailored to the specific strategy and characteristics of each individual fund or fund manager. 'Off the shelf' solutions should be avoided. Reviewing each individual context and designing a bespoke ESMS will ensure its continued relevance and use. Fund managers should consider their priority industry sectors and regions, and the associated ESG risks, impacts and opportunities. They should also consider how priorities might change over time and how successor funds may require slightly different approaches. In addition, fund managers should review experiences to date (e.g. from existing portfolio companies or exits) and should map out and understand the role and ESG requirements of both current and possible future Limited Partners (LPs).

The ESGMS should be proportionate to the types and magnitude of ESG risks that the fund is likely to encounter in its investments. It is important to try to keep it simple, and align the scale with the complexity of the likely risks and impacts. The best management systems are not necessarily those supported by the longest and most detailed documents and procedures, but those that speak directly to the context of the fund manager's strategy, activities, priority sectors and locations and addresses pertinent risks, impacts and opportunities in adequate but not unnecessary detail.

Finally, engagement with the whole investment team will build a picture of current practice and how ESG management should best be built into any existing investment processes. Many fund managers already include ESG aspects in their day-to-day company engagement without labelling it as 'ESG'. It will be important to understand if there are any gaps in those practices and consider how to embed the new ESG practices into the culture and language of the fund.

Assigning roles and responsibilities

Each fund will be different when it comes to assigning roles and responsibilities within the investment team. It will depend on a number of factors such as team size and structure, portfolio composition and the investment model/strategy. However, any structure should include appointing a senior executive and an ESG Officer (or Officers) to take accountability and responsibility, respectively, of the ESGMS.

- ***Accountability - senior management providing support and oversight:*** There should also be oversight and support at a high level, for example a Senior Partner who sits on the IC. This person should be able to ensure adequate time, resources and commitment are being paid to ESG matters during the whole investment process and should act as a check and balance to ensure ESG matters are properly managed.
- ***Responsibility - ESG Officer(s):*** The fund manager should appoint a person with the time, experience/knowledge and/or interest to take day-to-day responsibility for ensuring ESG is implemented in practice. Fund managers may consider hiring an external ESG specialist to support the implementation of the ESGMS. In some instances (e.g. funds focusing on investment in sectors with high ESG risks and impacts) the fund may decide to hire a full time E&S Officer. When assigning the ESG Officer role it is important to ensure their work is integrated into the investment process. They should therefore have the ability to talk to company management and be involved in due diligence and monitoring and ideally, have some independence from the Deal Officer leading on the transaction.

Engaging with colleagues

An increasing number of fund managers now have a requirement or ambition to address ESG issues. Some of the funds' employees may have worked at funds with ESGMS. Other colleagues may already clearly understand the need to address ESG-related risks and opportunities through their own experience of deals with exposure to potentially high risk sectors, such as extractives. There may also be members of the team who do not yet fully understand how ESG can be integrated into a successful investment process. In developing an ESGMS, it is vital that Investment Officers understand the ESG business case, ensure that the procedures introduced dovetail with existing processes, and make sure that they are effectively implemented.

Engaging with LPs

Many LPs (and all Development Finance Institution (DFI) LPs) will have clear expectations of, and relevant experience around, ESG management and performance as a result of the funds they already invest in. They should usually therefore be able to provide guidance regarding ESG management. Engaging early on with LPs to understand what their requirements and expectations are is key. Early engagement with LPs also allows the fund to benefit from LPs' expertise and guidance and maximise consistency and alignment of ESG requirements across investors/LPs.

Deciding when and how to engage consultants

All funds will need to consider whether and when to use consultants. In some cases external advice may be needed to help develop and implement the ESGMS or, for example, for specific transaction support. Some fund managers have compiled a database of preferred specialists to be called upon for specific input to identify risks or opportunities during the due diligence or ownership phases. It can be useful to determine when external expertise should be sought (e.g. for investments triggering specific ESG risks or impacts, or those in particularly complex or challenging sectors or geographies).

Continuous improvement

Any effective ESGMS is one that provides clear guidance to address ESG risks, impacts and opportunities across the portfolio and entire investment cycle, while remaining flexible enough to accommodate improved processes and changes to the portfolio or investment process (e.g. a change in the fund’s sector focus). It is important to regularly revisit the system (e.g. once a year) to make adjustments and improvements over time and to implement the lessons learnt from applying the tools and using the system. There should be a clear approval process for any resulting updates to the system.