Subjective issue

CLO managers are increasingly investing in their own methodologies and disclosure processes to provide investors with helpful ESG information. However, as **Corinne Smith** reports, the subjective nature of this data remains an issue.

The SFDR RTS and TCFD reporting for large UK asset managers and asset owners both became mandatory on 1 January 2023. In the case of CLO investments, investors rely on CLO managers to provide the information necessary for them to comply with their obligations under the rules. However, while some CLO managers have invested in their own methodologies and disclosure processes to provide investors with helpful ESG information, the subjective nature of this data remains an issue.

The SFDR applies to 'financial market participants' that offer 'financial products' and 'financial advisers', while the TCFD rules apply to FCA-authorised asset managers. "Investors are caught by these rules and therefore have to adhere to certain reporting requirements, including how they integrate sustainability risks into investment decision-making and how they consider principal adverse impacts of their investments on sustainability factors. In the case of CLO investments, investors rely on CLO managers to provide the information necessary for them to be able to comply with their obligations," says Jennifer Ellis, counsel at Linklaters. ▶

Jennifer Ellis, Linklaters

With investor demand for ESG disclosures rising, more and more CLO managers are implementing investment guidelines and procedures that take ESG considerations into account. Some CLO managers are opting to go further and develop specific ESG policies and their own internal scoring methodologies, whereby an asset must have a minimum ESG score at the time of acquisition to be eligible for inclusion in the portfolio.

Ellis notes that in some recent deals, CLO managers have also agreed to comply with certain initial and ongoing ESG due diligence requirements. These typically include an obligation on the CLO manager to use commercially reasonable efforts when selecting assets for investment to review due diligence materials, attend investor presentations or conduct management meetings and examine publicly available third-party information. For assets already in the portfolio, CLO managers are obliged to attend management meetings, conference calls or other events relating to the relevant obligor and monitor on an ongoing basis the industry and sector trends relating to that obligor.

In terms of investment guidelines, CLOs can incorporate ESG-related provisions focused on negative screening of obligors via the eligibility criteria and some are moving towards positive screening through the inclusion of ESG-related portfolio profile tests *(SCI 11 February 2022).* Positive screening frameworks can either require a certain percentage of the portfolio to be comprised of ESG assets or employ a more thematic investment approach, whereby the CLO manager invests in assets that provide exposure to specific sustainability themes.

In terms of ESG reporting, an increasing number of managers are providing principal adverse sustainability impact (PASI) statements, in line with the SFDR RTS. This approach involves quantitative disclosures – including data on 14 key indicators (nine relating to the environment and five relating to social factors) for assessing adverse sustainability impacts across a range of ESG factors – and qualitative disclosures, including information about policies on the identification and prioritisation of PASIs, information on engagement policies and policies relating to reducing principal adverse impact (PAIs), and reference to adherence to responsible business conduct codes.

Denis Struc, portfolio manager at Janus Henderson Investors, views certain PAIs and their recommended measures as somewhat "aspirational" for a number of fixed income strategies, given the scarcity of information available to assess them. He points out that the PAIs range from matters of sustainability that can be reasonably quantified to others that are much harder to measure at the present time.

Denis Struc, Janus Henderson Investors

"A NUMBER OF MEASURES ADDRESS CARBON-RELATED RISKS AND ARE BROADLY ALIGNED WITH OTHER RECOMMENDATIONS"

"A number of measures address carbon-related risks and are broadly aligned with other recommendations, such as TCFD, but there is a paucity of data for others that makes them more challenging to assess. This doesn't mean they don't need to be addressed – we're advocates of sustainability and use our leverage as investors to influence change – but finding the right data to accurately measure outcomes can be very difficult for many strategies," Struc argues.

He cites biodiversity as an example. "I am not sure we have a clear understanding of what counts as 'biosensitive' or what counts as having a negative effect on biosensitivity. Without data, where do you start in terms of plausibly developing these definitions? Unlike for carbon, there remains a steep education curve in terms of understanding the metric and what counts as 'good' or 'bad'. As such, it makes sense that there is greater focus on carbon in the first instance, as it is more quantifiable."

Meanwhile, Ellis suggests that the latest trend to emerge in the CLO ESG space is additional periodic reporting. She cites Fidelity Grand Harbour CLO 2022-1 as an example, the documentation of which includes a requirement to report periodically on the average ESG score (reflecting an obligor's overall adherence to certain ESG factors) of the portfolio, as well as the obligors that have been added or removed from the portfolio as a result of their compliance with certain ESG factors.

"Currently, this level of reporting is still very much provided at the CLO manager's discretion and only a handful of managers have elected to do it so far. However, we do expect this activity to grow, due to the availability of ESG scores," Ellis observes.

Broadly, three streams of ESG CLOs appear to be emerging: those with standard exclusionary lists, or 'ESG negative' transactions; those with ESG scoring and reporting provisions, whereby deals report an ESG score but there is no obligation to meet or achieve a certain minimum score; and those with an 'ESG positive' approach, where a contractual minimum ESG positive metric for the portfolio is set out, which the manager uses reasonable endeavours to achieve. Anecdotally, Fidelity International is one CLO manager that stands out for its ESG positive approach.

Although some CLO managers have invested heavily in their own methodologies to provide investors with helpful ESG data, the subjective nature of this data remains an issue, according to Ellis. "Data points differ from one manager to another, which makes it difficult for investors to compare different deals. It is likely more managers will look to start utilising third-party ESG score providers, in response to investor demand and to enable investors to more easily compare deals in the market from an ESG perspective."

CLO document review service Review Port recently introduced a CLO ESG provisions screening system, based on the quality and consistency of CLO manager ESG provisions in offering documentation. "In most cases, definitions of what constitutes ESG for a given CLO are determined solely by the CLO manager, which means it is impossible to monitor without subsequently offering reporting on ESG considerations. The idea behind the Review Port CLO ESG provisions screening is to allow investors to compare and differentiate between managers' ESG provisions, including noting if there are any internal ESG scoring, reporting requirements or due diligence procedures pre- and after-purchase of collateral obligations," explains Daniel Kakonge, founder and research director at the firm.

He adds: "The challenge is offering reporting across the market, as some managers still get away without offering any ESG reporting, which makes it harder for investors to track ESG consideration progress. For instance, with reporting requirements or due diligence procedures pre- and after-purchase of collateral obligations, if a credit becomes non-compliant with a manager's ESG investment policy, the credit can be disclosed in a report. We're seeing more and more investors requesting for reporting or due diligence procedures, with the documentation being redrafted accordingly."

Similar to the climate PAIs set out in the SFDR RTS, the FCA encourages in-scope firms to consider making disclosures available to clients via TCFD product reports. Each report should contain portfolio level disclosure on these mandatory metrics: Scope 1 and 2 GHG emissions; Scope 3 GHG emissions (disclosure for Scope 3 is delayed until 30 June 2024); total carbon emissions; carbon footprint; and weighted average carbon intensity (WACI).

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Struc points to the variety of recommendations in sustainability reporting under various regimes and the number of different angles that investors have to be aware of, all of which require robust data in order to be adhered to. "The FCA is seeking to clarify the regime for labelling funds – it seems with a focus on core objectives and outcomes – while current EU regulations seem to be more quantitative in their approach, certainly for Article 8 funds," he observes.

Pursuant to the SFDR, Article 8 funds are defined as "promoting environmental or social characteristics", while an Article 9 fund has "sustainable investment as its objective" and a higher threshold for compliance. To date, a handful of European CLOs have been marketed as being "aligned" with Article 8.

In contrast, 307 Article 9 funds – representing a combined AUM value of €170.1bn – were downgraded to Article 8 in 4Q22, according to Morningstar data. The firm suggests that this migration to a less stringent category is being driven by uncertainty about how sustainable investments are defined.

At present, Struc suggests that it's more realistic to look at sustainability related to CLO managers rather than their portfolios. "It's an immediate win to look at aspects like talent development and inclusive hiring practices. On a relative basis, you can place managers above or below the average and then engage with the managers below that bar to create a constructive dialogue in terms of the path they're intending to follow."

CLO investors can also overcome the information barrier to an extent by asking the right questions of CLO managers. ELFA's CLO Manager ESG Diligence Questionnaire – which aims to improve the quality of reporting and data around the carbon footprint, governance and diversity of managers, as well as underlying obligors *(SCI 26 October 2022)* – is proving helpful in this regard.

"The questionnaire provides direction in terms of what matters to investors in connection with sustainability. The next step is to encourage widespread adoption of it: the questionnaires were deliberately designed to cater for various CLO managers, from those who are quite advanced and ready to provide comprehensive information to those who are at the early stages on their sustainability path," Struc observes.

He suggests that the CLO industry has the potential to lead the rest of the fixed income market in terms of ESG disclosure. "Once a dataset is created off the back of responses to the questionnaires, it enables comparisons to be made across a range of sustainability measures that can best be analysed on a relative basis. The end goal is to push for change, but first we need to understand what we mean by change."

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