European CLOs: navigating the ESG landscape

ESG continues to gain traction in structured finance. Custodians want to advertise their products as sustainable and report appropriately to the regulators; customers want to make a difference and invest in products that have a sustainable impact. But while European CLOs are at the forefront of ESG standardisation in structured products, a lot remains to be done.

As regulators implement stricter ESG disclosure requirements, it is even more important for asset managers, asset owners and custodians to navigate the ESG landscape and be able to measure a transaction's ESG impact. However the lack of a standardised ESG scoring framework means that there are multiple ways of doing this based on what is being assessed (impact or risk), whether the analysis is qualitative or quantitative and whether scores are relative (normalised by industry) or absolute.

Because a CLO is a fund that invests in loans or bonds (typically leveraged loans), it is possible to compute an ESG score for the CLO by assigning ESG scores to each underlying borrower or issuer. Scope has focused on an approach[1] that assigns absolute principal adverse impact scores through an objective data-driven quantitative approach that is transparent (full disclosure of the model's data sources and its methodological limitations), comprehensive (encompasses the entire supply chain) and independent from issuers' own reported information. The fact that scores are absolute is important as it allows for peer comparison across industries and regions.

While there are additional facets to a CLO, such as the asset manager, the transaction's features and triggers, we looked at underlying borrower scores to analyse the sustainability of European CLOs.

Box 1: CLO selection process

Our analysis considered 420 European CLOs from 60 asset managers that closed between 2013 and the beginning of 2022.

We then scored the 575+ borrowers/issuers making up their collateral and checked the data quality for each CLO. Each absolute score ranges on a scale from 0 (the lowest) to 10 (the highest). It varied from 100% issuer coverage by nominal balance to a minimum of 67% for the most recent new transactions that are not fully ramped. When available, we then used the assets' expected Moody's or S&P industry scores to improve the coverage. Finally, we set the threshold to a minimum of 80% total portfolio coverage and a minimum current balance of EUR 100m.

The final result covers 410 CLOs[2] across 59 asset managers representing EUR 166.15bn in assets. Each CLO's scores are issuer-amount-weighted and each manager's scores are deal-amount-weighted.

Analysts

Benjamin Bouchet
+33 1 86 26 18 76
b.bouchet@scoperatings.com

Olivier Toutain
+33 1 82 88 23 56
o.toutain@scoperatings.com

Benoit Vasseur
+49 69 6677 38940
b.vasseur@scoperatings.com

Team leader

David Bergman
d.bergman@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related Research

European CLO outlook: rally continues apace amid ongoing uncertainty
January 2022

European CLOs: energetic start to 2021 but asset-quality concerns remain
April 2021

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

[1] For more information about ESG Impact Review, please visit ScopeOne
[2] A complete list of asset managers and number of deals can be found in the Appendix on p7

ESG regulations and features in CLOs

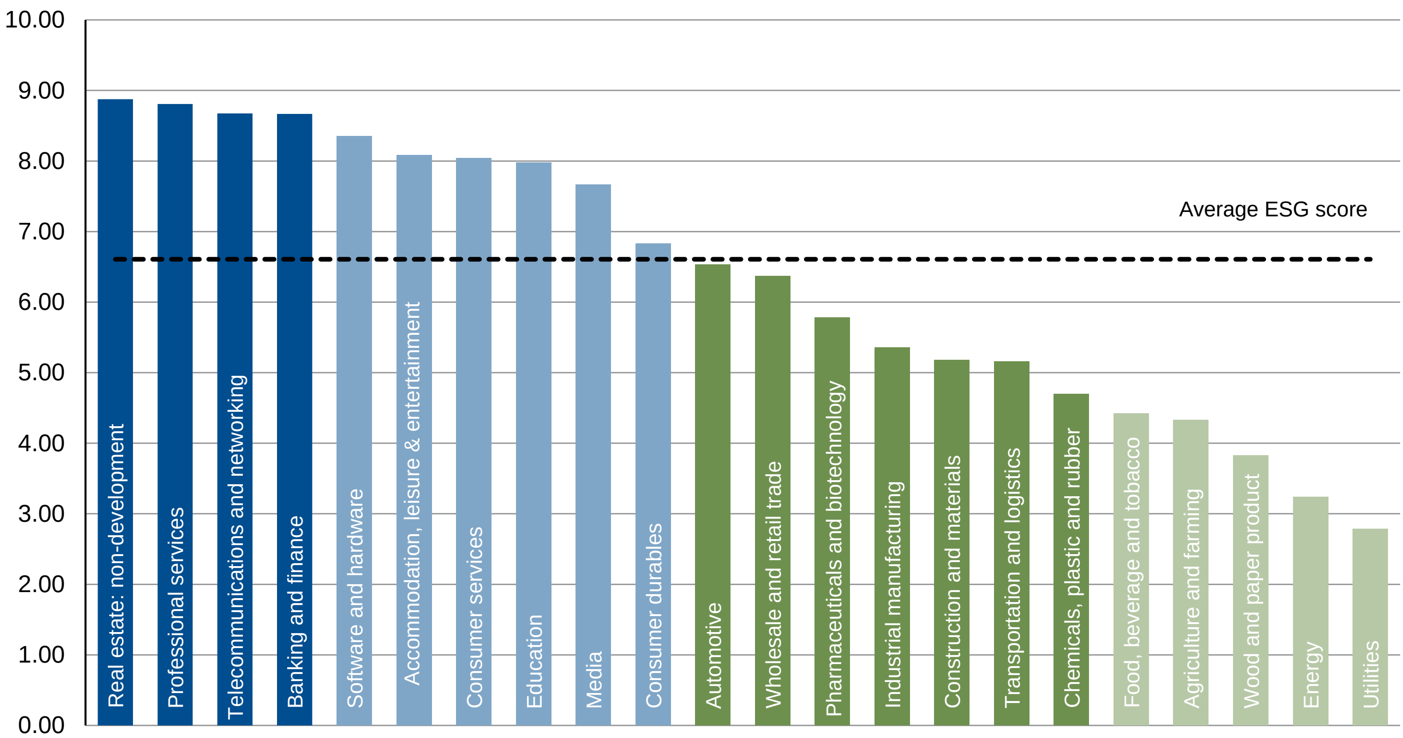
ESG disclosure becoming mandatory

From the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) recommendations to the European Commission's Taxonomy and Sustainable Finance Disclosure Regulation (SFDR), regulatory and voluntary frameworks are pushing for enhanced ESG disclosures, seeking to eliminate greenwashing and promote ESG investments. The initial phase of SFDR, which came into effect March 2021 requires asset managers to sort their EU-domiciled funds into "brown" (Article 6), "light green" (Article 8) and "dark green" (Article 9). The second phase, delayed until the beginning of January 2023, will introduce further prescriptive and detailed disclosure on 18 mandatory principle adverse impacts statements (PAIS). The European Securities and Markets Authority (ESMA) enhanced Articles 8 and 9 disclosure obligations in October 2021.

Negative screening is the most used ESG criteria

Negative screening through sector exclusion is the most widespread ESG feature in CLO documentation and has now become the norm. All of the European CLOs that were refinanced in 2021 incorporated such language. More industries are also being excluded, according to Morgan Stanley research[3]. Around 15% of prohibited lists excluded two or more industries in 2018; in 2021 it was close to 100%. As highlighted in our analysis, some sectors clearly have a much lower average sustainable score than others, thus a CLO which is reducing its exposure to these sectors could improve its score. However, the so called "vice" sectors (alcohol, arms dealing, tobacco) are not represented in any of the transactions we looked at, leading to questions as to whether negative screening is a differentiator between ESG and non-ESG CLOs.

Figure 1: ESG score per Scope industry breakdown



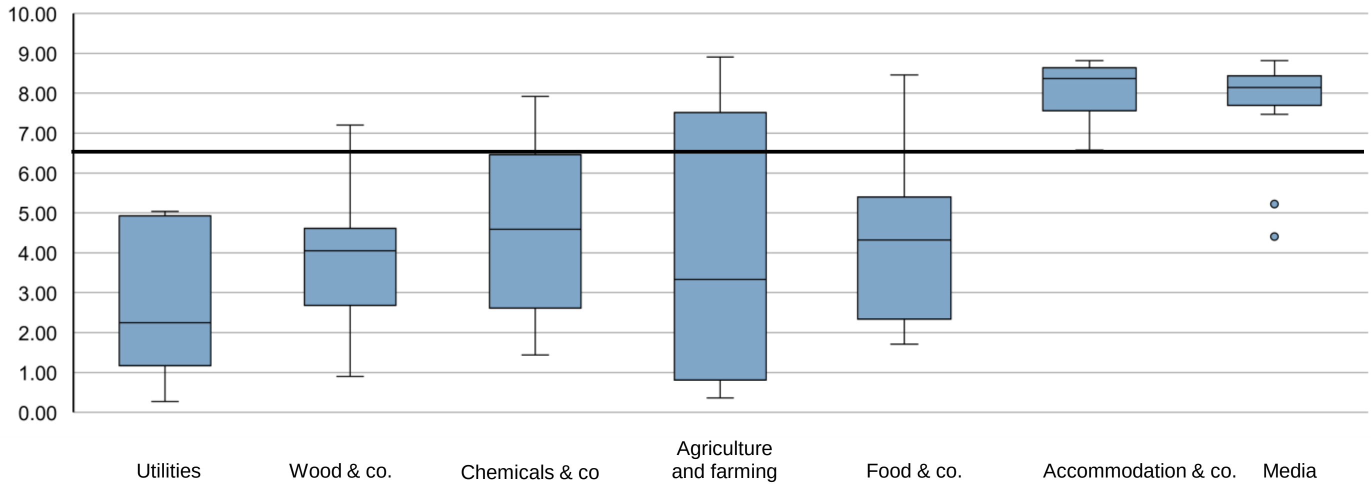
Source: Scope ESG Impact, Scope Ratings

[3] 2022 European ABS and CLO Outlook | Europe

Different issuers, same industry, but different scores

Within each industry, there are clear outperformers and underperformers. Looking at five sectors with low ESG scores, we note that 16 out of 113 issuers (14.2%) exhibit a score higher than the overall average of 6.61. Conversely, within two sectors that have good ESG scores (accommodation, leisure & entertainment; and media), four out of 55 issuers (7.3%) exhibit a score lower than the average. As such, while negative screening is a first-level approach, it may exclude issuers that score higher than the average issuer while including issuers that score lower.

Figure 2: ESG score dispersion per industry



The thick black line represents the average score (6.61)
Source: Scope ESG Impact, Scope Ratings

ESG integration and additional criteria developing

Following the above, another analysis first introduced in the CLO space in 2019 – positive screening – is achieving momentum through ESG integration. This adds another credit-by-credit layer of "pre-investment screening, borrower/transaction due diligence, monitoring and review process"[4]. Currently, only a handful of CLOs are implementing such a feature, which requires more disclosure. It is also generally used in conjunction with negative screening. Further ESG criteria are emerging such as best-in-class (invest in the best according to criteria such as carbon emission levels) or thematic investments (invest in names promoting a theme such as gender equality at board level).

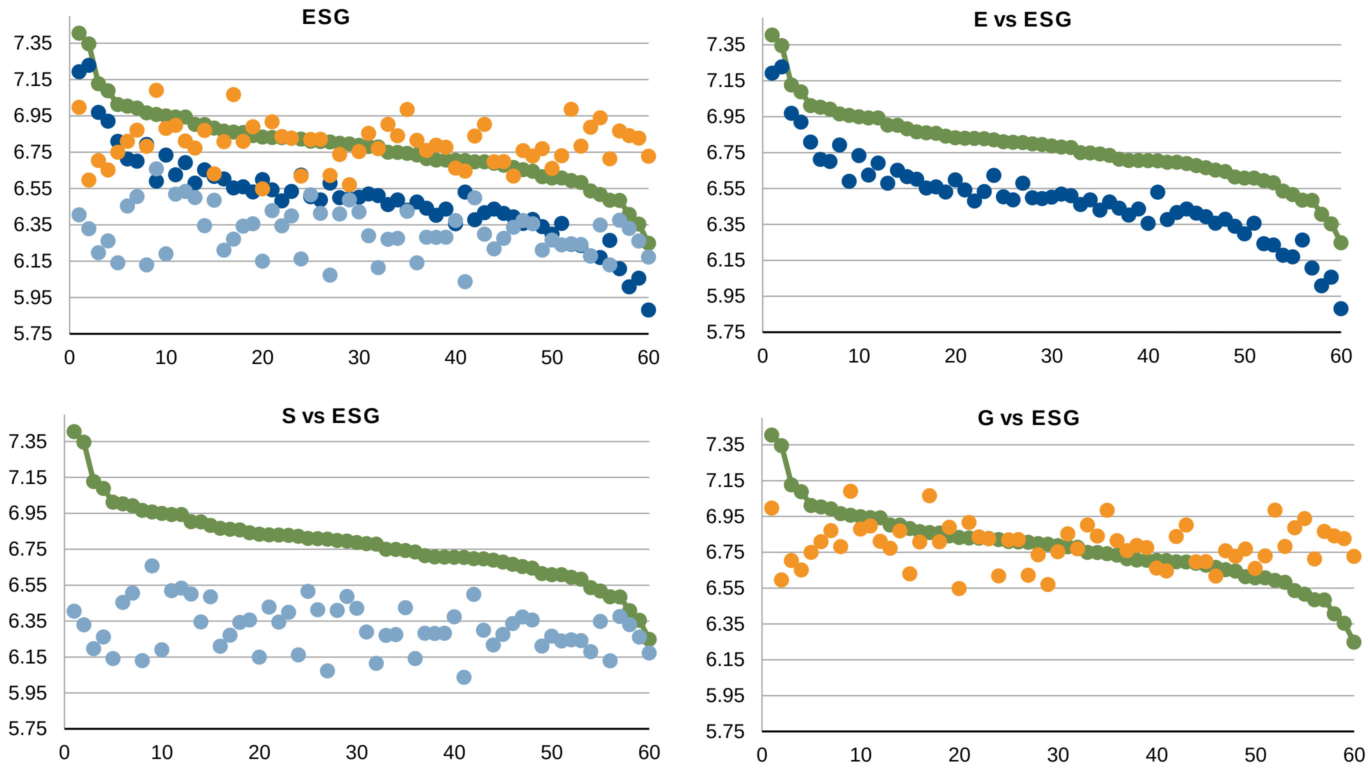
ESG driver and manager's investment style

The environmental impact is driving the ESG score

The correlation between the overall ESG score and the environmental score is extremely high at 0.98. That compares with 0.24 and 0.03, respectively, for Social and Governance scores. The Social and Governance scores marginally impact the absolute score but they are not drivers. Indeed the second most highly-rated asset manager has a higher Environmental score but a lower aggregated score because of lower Social and Governance scores.

[4] NIBC 19 Nov 2019 press release

Figure 3: Average E, S, G and overall ESG score per asset manager

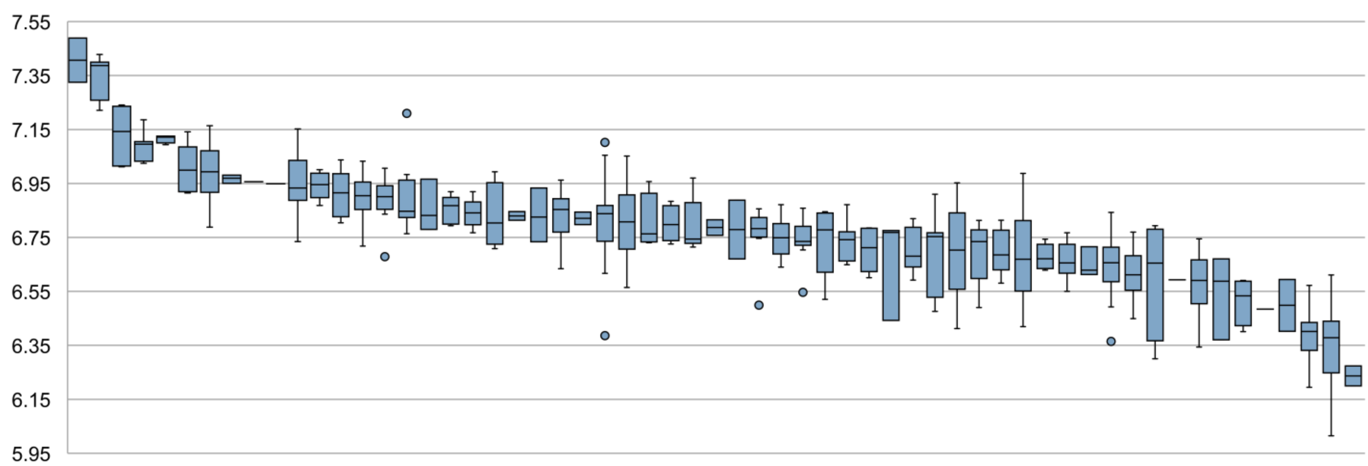


Source: Scope Ratings

Asset managers' investment style impacts the ESG score

Although issuer concentration in European CLOs is significant, asset managers exhibit different average ESG scores, which are relatively consistent across their deals (as evidenced by the relatively short box plots in Figure 4). That European CLO transactions have an important issuer overlap is reflected by the fact most of the CLOs in the European market are only exposed to 150-200 issuers, and the Top 10 issuers represent between 10%-15% of total pool composition. In our analysis of 410 transactions, the Top 10 issuers represent 7.34% of total CLO collateral. As such, the different ESG scores that the asset managers exhibit is a function of different investment styles.

Figure 4: Range of ESG scores per asset manager

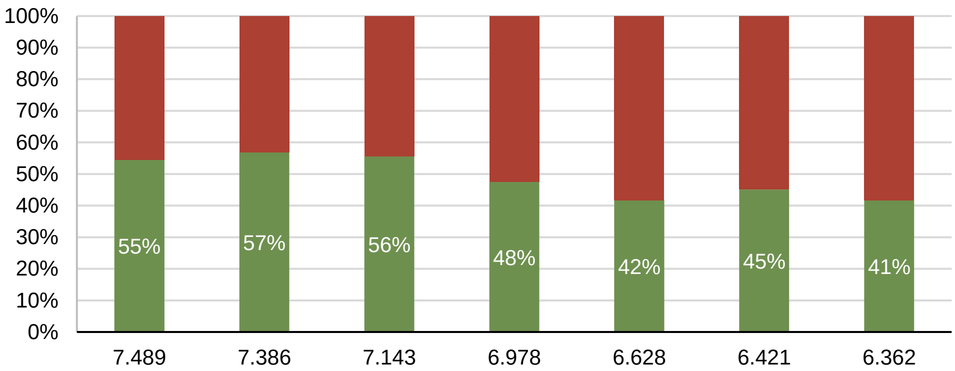


Source: Scope Ratings

Some managers are more efficient in their selection

Given concentration limits, a CLO manager cannot invest in only one sector that has a good ESG score. Issuer selection within a sector is the main way to score well in terms of ESG while maintaining some diversification. Some asset managers are taking advantage of issuer selection within a sector. Figure 5 shows the proportion of issuers within industries that do better or worse than the average ESG score of 6.61 for a selection of CLOs. The numbers on the x axis represent the CLOs' overall ESG Impact Score. A CLO with a 6.628 score (the third bar from the right) and 42% of underlying asset in green sectors can do better than the average 6.61 by identifying high-scoring issuers in both green and brown sectors.

Figure 5: Proportion of better or worse industries for a selection of CLOs

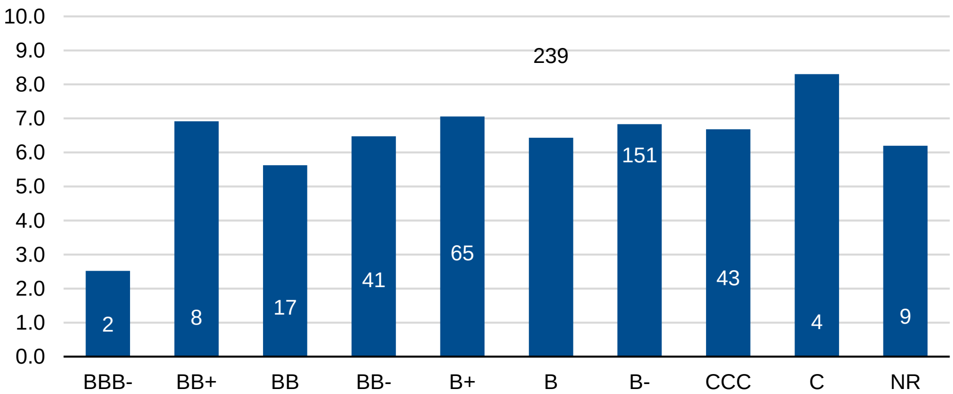


Source: Scope Ratings

A better credit rating does not mean a better ESG score

A credit rating is a forward-looking opinion regarding the relative creditworthiness of an issuer, an instrument or an obligation, and is assigned using an established and defined ranking system of credit-rating categories[5]. An instrument with a credit rating at the BB level reflects an opinion of moderate credit quality, while the C level reflects an opinion of exceptionally weak credit quality. From Figure 6, we can clearly see that there is no clear dependency between a leveraged loan issuer rating and its ESG score. However, as externalities and impacts along the supply chain are generally used in a company's risk assessment, we will likely see more convergence as ESG becomes more relevant in credit analysis.

Figure 6: Average ESG score and number of issuers per issuer credit rating[6]



Source: Scope Ratings

[5] Please refer to Scope's Credit Rating Definitions for more details
[6] Credit rating refers here as the second-best rating or if only one rating is available

Limits and future of ESG

CLO 2.1

Given the number of second-party opinions provided at issuance on certain ABS[7], as well as studies by members of the Eurosystem on how to assess ESG factors in ABS[8] or develop a framework[9], there are different ways to evaluate ESG. However, CLOs can play a major role in the sustainability agenda by standardising ESG disclosures in the leveraged loan market, which could also lead to the ongoing demystification of structured products. To make it easier for all parties involved, we will likely see an upgraded version (CLO 2.1), both to cater to investors who needs assurance on the ESG nature of the product as well as regulators, who would like to eliminate greenwashing.

Data input quality and objectivity

As highlighted earlier, the data in the model we have considered come from internationally recognised institutions, and the model itself is based on 11 indicators: five environmental, four social and two governance. The model outputs for specific industries and countries appears to be more refined for environmental indicators than the others, probably due to better data quality regarding environmental factors. Indeed, in general, the disclosures most companies provide regarding compensation, gender inequality or tax avoidance have a lot of room for improvement. More standardised disclosure will also make it possible to account more accurately for company specificities and thereby improve the impact from issuer selection within sectors or countries.

However, introducing company specificities into ESG assessments without improving disclosure will most likely only improve the score rather than adjust the score based on how the issuer performs against a global set of standards. For instance, while companies generally report on how well they are doing in terms of board diversity, few are reporting their gender pay gap. In the current state where ESG disclosures are mostly made on a voluntary basis with little to no standardisation or audit of the measures and/or processes implemented, the ESG assessment score will be more objective the fewer specificities it considers, which is clearly sub-optimal from an issuer selection point of view.

A robust and transparent process

An ESG score or rating must be reliable whether it comes from the asset manager or a third party. The process needs to be robust and transparent so that all market participants are comfortable with it. With regulations tightening and the need to avoid greenwashing, a strong dedicated ESG team or using advisers is necessary, in our opinion, along with proper disclosure and reporting.

---

[7] River Green Finance 2020 DAC CMBS or the Green STORM RMBS for instance
[8] Climate Risk Measurement of Assets Eligible as Collateral for Refinancing Operations – Focus on ABS
[9] EBA report on sustainable securitisation

I. Appendix. Number of CLOs per asset manager covered in the analysis

Asset Manager	No. of deals	Asset Manager	No. of deals
Accunia	4	GoldenTree	5
AlbaCore Capital	1	Guggenheim Investments	3
Alcentra	14	Hayfin Capital Management	7
Anchorage Capital	4	HPS Investment Partners	6
Angelo Gordon	4	Intermediate Capital Group	11
Apollo Global Management (Redding Ridge)	12	Invesco	7
Assured Investment Management (Fuji)	7	Investcorp Credit Management	19
Axa Investment Managers	6	KKR	16
Bain Capital Credit	10	Mackay Shields	2
Barings	12	Man GLG	6
Black Diamond Capital Management	3	Napier Park Global Capital	6
BlackRock	12	Nassau Corporate Credit	1
Blackstone Credit	24	Natixis IM	2
BlueBay Asset Management	2	Neuberger Berman	2
BNP Paribas Asset Management	1	NIB Capital Bank	3
Bridgepoint Capital	2	Oak Hill Advisors	6
Brigade Capital Management	5	Oaktree Capital Management	9
Cairn Loan Investments	11	Onex Credit Partners	4
Capital Four Management	3	Palmer Square Capital Management	5
Carlyle Group	21	Partners Group	9
CBAM	3	Permira Credit	6
Chenavari Investment Managers	4	PGIM	19
CIFC Asset Management	5	PineBridge Investments	5
Commerzbank	3	Rockford Tower Capital Management	1
CQS Management	1	Sculptor	6
Credit Suisse Asset Management	13	Sound Point Capital Management	7
CVC Credit Partners	18	Spire Partners	8
Fair Oaks Capital	4	Tikehau Capital	5
Fidelity International	1	Voya Alternative Asset Management	6
Five Arrows Managers	8		

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer