ESG CLOs: The opportunities and challenges

Introduction

Environmental, social and governance ("**ESG**") considerations have taken centre stage in the European debt capital markets this year. We have previously written about this shift towards ESG in the context of ESG bonds and social loans. Arguably, the securitisation markets have been somewhat slower to adapt to this trend. This is quickly changing though, and nowhere is this more apparent than the collateralised loan obligation ("**CLO**") market.

The European CLO industry has been exceptionally busy in recent months and continues to grow, as evidenced by the number of new entrants to the European CLO market over the last 18 months, with Ireland now being the sole domicile of choice for European CLO issuers. The industry has also been operating in a rapidly evolving legal environment, as market participants have grappled with revised transparency requirements under the Securitisation Regulation, the end of the Brexit transition period and the re-establishment by the UK of its own securitisation regulatory regime.

Now that the dust is beginning to settle from these changes, ESG considerations are quickly becoming a main topic of discussion in the market and, in many instances, this is being driven by investor demand. This article will discuss the emerging trend of ESG-focused CLOs and some of the opportunities and challenges that may face market participants as they seek to bring their own ESG CLOs to the market.

Early adopters

The PRI, an international organisation dedicated to the stewardship and promotion of the United Nations' Principles for Responsible Investment, has recently published a report on the incorporation of ESG principles in securitised products (the "**PRI Report**"). The PRI Report focuses in particular on the CLO industry and provides an interesting overview of progress in the ESG CLO market to date. It includes a list of 16 ESG CLOs that have already launched in the European market.

Although the first CLO to include ESG principles in its documentation (Providus CLO I) launched in early 2018, the pace of ESG CLO issuance increased in 2019 and 2020. So, too, did the level of incorporation of ESG principles into the documentation. North Westerly VI, a CLO managed by NIBC Bank and arranged by Mitsubishi UFJ Financial Group, launched at the end of 2019 as the first CLO which went beyond the exclusion of certain industries to incorporate the individual scoring and monitoring of borrowers based on their ESG performance.

The industry response to these early adopters has been positive. ESG CLOs have consistently generated headlines in the main industry publications, and North Westerly VI was recently announced as the Structured Finance and Securitisation Deal of the Year at the IFLR Europe Awards 2021. More recently, North Westerly VI was followed by another NIBC-managed ESG CLO, North Westerly VII, which follows broadly the same approach to the incorporation of ESG considerations as North Westerly VI.

How do they work?

There is no standardised definition of an ESG CLO. Moody's recently noted that 85% of European CLOs issued in 2020 and 2021 incorporated ESG criteria, to some extent. It is questionable whether all such CLOs could be considered "ESG CLOs", or whether something more is required. Nor is there any standardised approach to incorporating ESG considerations into CLOs; different managers have sought to differentiate their deals in different ways.

One of the most common and basic forms of ESG screening is industry-based screening. Collateral obligations of obligors that operate in certain specified industries are ineligible for inclusion in the deal. Coal-based energy production, the manufacturing or trading of certain controversial weapons or hazardous chemicals, tobacco, pornography and prostitution are examples of commonly excluded industries. However, deals differ in what additional industries may be excluded, in the "materiality threshold" used to determine if an obligor belongs to an excluded industry, and as to whether (and to what extent) the manager has discretion in determining compliance with ESG-prescribed criteria under the transaction documentation.

Going beyond industry screening, some managers are looking for additional ways to ensure that their portfolios are ESG-compliant. The concept of ESG scoring of obligors involves allocating each obligor an individual score based on various ESG-related factors. Obligors who score poorly may be excluded, and the manager may also apply portfolio-level tests based on the aggregated ESG scores of obligors in the portfolio. Managers may further demonstrate a CLO's ESG credentials by monitoring obligors in the portfolio for ESG compliance on an ongoing basis, and by undertaking periodic ESG reporting to investors, in addition to other reports mandated under the Securitisation Regulation. By way of example, these are some of the key innovations that were introduced in the North Westerly VI CLO mentioned above. However, there is currently no standardised approach to the scoring or monitoring of obligors, or to periodic ESG reporting.

Focusing on the assets in the portfolio is only one of several approaches to enhancing a CLO's ESG credentials. According to reports, one recent US CLO, CIFC Funding 2021-IV, involved donations by several transaction parties – and their lawyers – to a non-profit organisation dedicated to racial equality.

Regulatory considerations

Clearly, the most significant recent regulatory development in this area is the EU Sustainable Finance Disclosure Regulation ("**SFDR**"), which applies to a broad range of financial market participants and aims to increase transparency and prevent "greenwashing" by requiring enhanced disclosure in respect of ESG products. While CLO issuers themselves are unlikely to be subject to the SFDR directly, EU-based CLO managers that are credit institutions or investment firms are likely to fall within the scope of the SFDR on the basis that they provide portfolio management services.

Broadly, such managers will be required to disclose certain information about (a) how they integrate sustainability risks into their investment decision-making process, and (b) whether (and, if so, how) they take into account principal adverse impacts of investment decisions on sustainability factors. These requirements apply to all in-scope managers (whether or not the relevant CLO was marketed as an ESG CLO).

Where a financial product promotes ESG characteristics or objectives (commonly referred to as a "light green" product) or has sustainable investment as its objective (commonly referred to as a "dark green" product), the required disclosures must include information on how those characteristics or objectives are to be met. Such financial products (which may include ESG CLOs) will also be subject to periodic reporting with effect from January 2022. The precise details of the presentation and content of such disclosures and reports will eventually be set out in regulatory technical standards, which have not yet been finalised.

In a typical CLO structure, it is likely that the manager's disclosure and reporting obligations under the SFDR will be owed directly to the CLO issuer, rather than the CLO investors. However, the issuer may in turn be obliged to make such disclosure and reporting available to investors, either by agreement or pursuant to the Securitisation Regulation transparency requirements and / or the Market Abuse Regulation. The precise form of such disclosure and reporting is likely to be a topic for discussion amongst managers, investors and arrangers, at least until the relevant regulatory technical standards are finalised.

It is significant that the UK has not implemented the SFDR into its domestic law. Although specific advice will need to be taken in each case, it is possible that many UK-based managers of European CLOs will be outside the jurisdictional scope of the SFDR. Given that the aim of the SFDR is to enhance and standardise ESG-related disclosure, it remains to be seen whether the divergent regulatory regimes in the EU and the UK will lead to segmentation in the sector and, if so, whether the increased requirements of the SFDR will ultimately help or hinder EU-based managers attempting to bring ESG CLOs to the market. In this regard, we have seen some early evidence of non-EU managers committing to use commercially reasonable efforts to comply with reporting provisions equivalent to those set out in SFDR in their deals.

At present, the SFDR is the main regulation of relevance to ESG CLOs in the EU (alongside the EU Taxonomy Regulation, which is intended to provide a common language for firms and investors to identify which economic activities are "environmentally sustainable"). However, the regulatory response to the rise of ESG investing is arguably in its early stages, and market participants will be watching closely for further initiatives that may impact on the CLO sector. For example, the European Commission is expected to complete its reviews of the Securitisation Regulation and the Capital Requirements Regulation in early 2022 – it will be interesting to see whether any ESG-related amendments to those regulations are proposed.

The road forward

All signs point to strong growth in the ESG CLO sector (and other ESG financial products) in the near future. Moody's recently predicted that ESG CLOs will continue to evolve over the next two to five years, driven by regulatory initiatives and strong investor demand. However, there are numerous challenges that market participants will need to overcome if ESG CLOs are to become truly mainstream.

The PRI Report identified several factors which market participants consider to impede the growth of ESG CLOs. According to that report, a lack of adequate data to enable ESG due diligence is one of the key factors preventing investors from systematically incorporating ESG considerations into their analysis of securities products. In the CLO context, investors rely heavily on managers to undertake due diligence of underlying obligors. It may therefore become increasingly important that ESG CLOs contain comprehensive disclosure – in offering documents, transaction documents and ongoing reporting – of the processes and criteria used by managers to ensure that the portfolio is ESG-compliant throughout the life of the deal, with the possibility of independent third-parties verifying the data to ensure compliance and provide comfort to investors. The PRI Report also pointed to a lack of standardisation in deal documentation as impeding the proper analysis of ESG CLOs.

More broadly, some have noted that, in practice, ESG criteria have a very limited impact on portfolio composition. Moody's have suggested that this is due to the limited scope of the ESG criteria in many deals, as well as the fact that the industries most commonly excluded as part of ESG screening processes are not ones that CLOs typically invest heavily in anyway. If this situation continues, it may cause some to question the relevance of ESG criteria to CLOs. However, as managers begin to employ more sophisticated, prescribed and transparent techniques for assessing the ESG performance of obligors, we may begin to see increased differentiation between ESG and non-ESG portfolios.

Perhaps due to the factors outlined above, no clear price differential has yet emerged between ESG and non-ESG CLOs, with ESG CLOs pricing largely in line with their contemporaneous non-ESG counterparts. If and when approaches to ESG CLOs become more standardised in the market, and increasing standards result in the exclusion of more obligors from portfolios, the true value of the ESG label to investors should become apparent, particularly if certain investors have a fixed mandate to invest in ESG-compliant financial products.

Conclusion

The development of the European ESG CLO market is well under way. Industry-based ESG screening is fast becoming the norm for new deals, and the bar for ESG incorporation is continuously being raised, helped by market innovations and regulatory initiatives. A number of technical, commercial and legal challenges must be overcome if the pace of growth is to be maintained, and some of these challenges may require cooperation at an industry level. However, the forces driving the growth of ESG CLOs are strong, and it seems reasonable to conclude that this is a trend that will continue into the near and medium term.

As Ireland is the leading European CLO issuer domicile of choice, we have extensive experience on advising a broad and diverse range of CLO issuers and managers on CLO transactions and, in collaboration with our recently established ESG Advisory Group, we have acted on a number of recent CLO transactions that incorporate ESG elements.

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