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ELFA *Insights*
Volume 10

Why leveraged finance investors need more disclosure on ESG topics, and how this can be addressed

Executive Summary

- Over the past few years, credit investors have widened and refocused their investment analysis to includemore information on environmental, social, and governance (ESG) topics.
- As a result, a rapidly expanding number of investors are requesting from borrowers ESG information that they consider material to their investment decisions, with many relying on proprietary questionnaires to gather this information.
- Deal teams have reported receiving upwards of a dozen or more questionnaires on every high yield bond and leveraged loan deal.
- The increase in requests for this information is propelled by three main factors: (1) mounting evidence that ESG analysis is additive to the investment process; (2) continuously emerging regulatory requirements that oblige asset managers (and borrowers) to disclose how they are managing the financial risks relating to sustainability; and (3) increasing demand by end investors for asset managers to demonstrate that they incorporate ESG considerations into investment products and processes.
- Borrowers and their advisers are concerned about the substantial overlap between questionnaires, which result in inefficiencies when deal teams nonetheless are asked to reply to individual questionnaires; investors, for their part, would prefer disclosure on ESG topics to be included in company reporting.
- The ELFA believes that the growing disconnect between the increased demand by investors for ESG information and the existing level of disclosure provided by sub-investment grade corporate borrowers, left unaddressed, will likely lead to increased inefficiencies.
- We propose that companies disclose ESG information to investors by way of the existing offering and periodic reporting framework.
- To this end, the ELFA is working together with the PRI to create tools to support engagement between sub-investment grade corporate borrowers and investors on ESG matters.
- Ultimately, the ELFA hopes that this dialogue will move beyond basic facts to more business-relevant ESG subject matters, positioning borrowers to better engage with investors and reap the opportunities that a more progressive ESG approach can bring.

Introduction

Credit investors rely on quality financial disclosure by borrowers to inform the analysis underpinning their investment decisions. Over the past few years, this analysis has widened and refocused to include more information on environmental, social, and governance (ESG) topics. A rapidly growing number of investors are now requesting from borrowers ESG information that they consider material to their investment decisions, with many relying on proprietary questionnaires to gather this information.

As the number of investors focused on ESG topics has increased, so has the number of questionnaires that borrowers receive. According to one sell side participant that the ELFA spoke to, at the beginning of 2019 they might receive one or two questionnaires from investors on every other deal, but by the end of the year deal teams were receiving upwards of a dozen or more on every deal, across both high yield bonds and leveraged loans.

Borrowers and their advisers have questioned the need for these questionnaires, particularly as some of the questions seem not to relate to risks that are relevant to that particular company's business model. Further, there is substantial overlap from firm to firm, resulting in inefficiencies when deal teams nonetheless are asked to reply to individual questionnaires. Understandably, market participants seek justification for the time and resource spent answering ESG questionnaires from investors, and the market is keen for more consistency in this area.

In this note, we explore the main drivers behind investors' need for more ESG disclosure from borrowers. First, there is mounting evidence that ESG analysis is additive to the investment process. Second, regulatory requirements continue to emerge that oblige asset managers (and borrowers) to disclose how they are managing the financial risks relating to sustainability. Finally, asset managers are reporting

ever increasing demand by their end investors to prove that they incorporate ESG considerations into investment products and processes.

The growing disconnects between the increased demand by investors for ESG information and the existing level of disclosure provided by sub-investment grade corporate borrowers, left unaddressed, will likely lead to increased inefficiencies. We believe that the best way for companies to disclose ESG information to investors is by way of the existing offering and periodic reporting framework. This approach has several material benefits, which we explore in this note.

To further this goal, we are working together with the PRI to create tools to support engagement between sub-investment grade corporate borrowers and investors on ESG matters. By promoting consistent minimum levels of ESG disclosure at the sector level and formalising the inclusion of ESG information in offering documentation and periodic reporting, we believe that engagement will become more efficient and effective.

ESG materiality and the mounting evidence that a more systematic incorporation of ESG considerations into credit analysis is additive to the investment process

The link between financially material ESG considerations and returns is becoming clearer. This has been confirmed by myriad sources, including a comprehensive study carried out in 2015.[1] The study found a positive correlation between ESG and corporate financial performance, and concluded that "the business case for ESG investing is empirically very well founded". In addition, a study from Axioma showed that "in general, increasing exposure to ESG rarely underperforms the market, and often outperforms the market, especially during the last few years".[2]

Further, the evidence that systematic incorporation of ESG considerations can lead to more informed investment decisions, with ESG being seen as a proxy for quality, continues to emerge. There is a growing recognition that ESG issues are credit-relevant and can pose material risk to investments with the potential for significant losses. As a result, investors are focused on the fundamental ESG factors that can have an effect on cashflows, and will therefore impact enterprise value, and as a result, credit risk.

> *"What is considered appropriate corporate practice will vary from one sector to another, such that each sector has its own unique ESG or sustainability profile."*

In this context, it is important to understand ESG risks through the lens of materiality. The Financial Accounting Standards Board defines materiality as: "… information which would be considered decision-relevant to an investor", and the Sustainability Accounting Standards Board considers financial material issues as "… those issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors".[3] Companies, together with their advisers, ultimately decide what is financially material and should therefore be disclosed, taking in account legal requirements and the views of their key stakeholders.

In reviewing the relationship between a company's performance on ESG issues and its financial performance, not all ESG issues matter equally. Material ESG issues are those reasonably likely to have a material impact on a company's financial performance. There are a broad range – or universe – of possible ESG issues, with some being core for all companies. However, given that each of these issues tends to have a different impact or consequence depending on the context in which it arises, what is considered appropriate corporate practice will vary from one sector to another, such that each sector has its own unique ESG or sustainability profile.

Growing regulatory requirements from governments and policy makers

As a result of the increasingly systematic economic risks posed by certain ESG issues like climate change, regulatory requirements continue to emerge that oblige asset managers (and borrowers) to disclose how they are managing these risks. The regulatory efforts also aim to drive the allocation of capital towards more sustainable economic activities. Whilst this is a global trend, Europe is at the forefront of this movement.

[1] ESG and financial performance: aggregated evidence from more than 2000 empirical studies by Gunnar Friede, Timo Busch & Alexander Bassen.
[2] Thompson J. (2018) 'Companies with strong ESG scores outperform, study finds' Financial Times, 12 August [Accessed: 28 October 2020]
[3] https://www.sasb.org/standards-overview/materiality-map/

Four key legislative initiatives are of particular relevance to asset managers, some of which are responsible for the increase in investor information requests to borrowers, as this category of ESG information is necessary for them to meet applicable requirements for inclusion in portfolios. Whilst it is a voluntary framework, regulators and policy makers are also reviewing mandatory Taskforce on Climate-related Financial Disclosures (TCFD) reporting for listed companies as well as certain financial institutions.

The EU's investment-related regulations are summarised in the table below, along with implications for asset managers and borrowers.

Regulation	Summary
Sustainable Finance Disclosure Regulation (SFDR)[4]	*In brief* • New disclosure obligations on how asset managers integrate ESG factors into their risk processes designed to make it easier for end-investors to make informed investment decisions. • Disclosure obligations include the publication by a firm of written policies on the integration of sustainability risks in investment decision making process, as well as explicit pre-contractual disclosures. • Although framed as rules about disclosures, there are significant business and policy decisions which firms will need to make in terms of how sustainability impacts on their investment processes. • Relevant to all in-scope asset managers. • Passed into law and applicable from 10 March 2021.
	Potential investor Impacts • Will have meaningful impact although application is not immediate • While the "comply or explain" logic inherent in some of the key disclosure obligations is helpful, managers will be conscious of reputational risks so will seek to ensure appropriately they incorporate sustainability risks into their investment policies to avoid the perception of inadequate risk management. • The need to make decisions about how they manage sustainability risks in their investments could lead some asset managers to adopt investment restrictions on certain borrowers based on the ESG profile of their economic activities and how well these are being managed.
	Potential borrower impacts • Investors will need company ESG data in order to be able to quantify sustainability risks and evaluate the extent to which they represent investment material risks as well as adverse sustainability risks to society.
Framework (or Taxonomy) Regulation[5]	*In brief* • Creates a new common taxonomy to be used in determining the degree to which an economic activity can be described as being "environmentally sustainable". • Enables asset managers and investors to demonstrate how environmentally sustainable a given investment and/or portfolio is. • Applies only to asset managers making available financial products with either an explicit objective of environmentally sustainable investment or which explicitly promote environmental characteristics. • All managers will at least need to make a negative disclosure to confirm that all out-of-scope financial products are indeed out of scope. • Passed into law and applicable from late 2021 / early 2022.
	Potential investor impacts • The scrutiny on portfolio taxonomy alignment could potentially amplify investor interest in and demand for such products. • Whilst technically not all managers will need to disclose the alignment of their investments/portfolios to the taxonomy, in practice it is likely that their clients will want to understand how their investment/portfolio stands in terms of alignment with the taxonomy.
	Potential borrower impacts • Investors will need company data on the extent to which their economic activities are within scope of the taxonomy, and if so, the revenue / capex / opex spend in order to determine whether this qualifies as a "significant contribution", as well as to understand whether the business has operated responsibly in terms of not doing significant harm, and ensuring minimum social safeguards.

[4] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.
[5] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

Regulation	Summary
Suitability Delegated Regulation[6]	*In brief* • This would amend the MiFID 2 Delegate Regulation to clarify that ESG considerations and preferences should be taken into account in the investment and advisory process as part of an investment firm's duties towards its clients when performing the 'suitability' assessment for portfolio management and investment advices. • Yet to be passed into law. Public Consultation expired 6 July 2020, under consideration by the Council of the EU and the European Parliament.
	Potential investor impacts • Potentially amplifies investor interest in and demand for products that integrate ESG factors, leading asset managers to increase availability of such products. However, the drafting makes clear that the rules apply "where relevant", whilst acknowledging that a client might not have explicit ESG preferences.
	Potential borrower impacts • The absence of ESG disclosure by borrowers could be perceived as indicative of weak ESG practices, reducing the likelihood that debt of these companies will be included in such products.
Integration of sustainability into a firm's systems and controls	*In brief* • Additional Level 2 delegated acts would make amendments to the existing Level 2 measures under the UCITS Directive[7] and AIFMD[8] and MiFID 2[9] respectively, to ensure that sustainability risks and sustainability factors are integrated within a manager's organisational, operating and risk management processes. • Yet to be passed into law. Public Consultation expired 6 July 2020, under consideration by the Council of the EU and the European Parliament.
	Potential investor impacts • The explicit references to sustainability risk will inevitably lead to greater scrutiny by firms and investors of such risks, particularly given the obligations placed on senior management. • The need to make decisions on how they manage sustainability risks in their investments could lead some asset managers to adopt investment restrictions on certain borrowers based on the ESG profile of their economic activities and how well these are being managed.
	Potential borrower impacts • Investors will need company ESG data in order to be able to quantify sustainability risks and evaluate the extent to which they represent investment material risks.

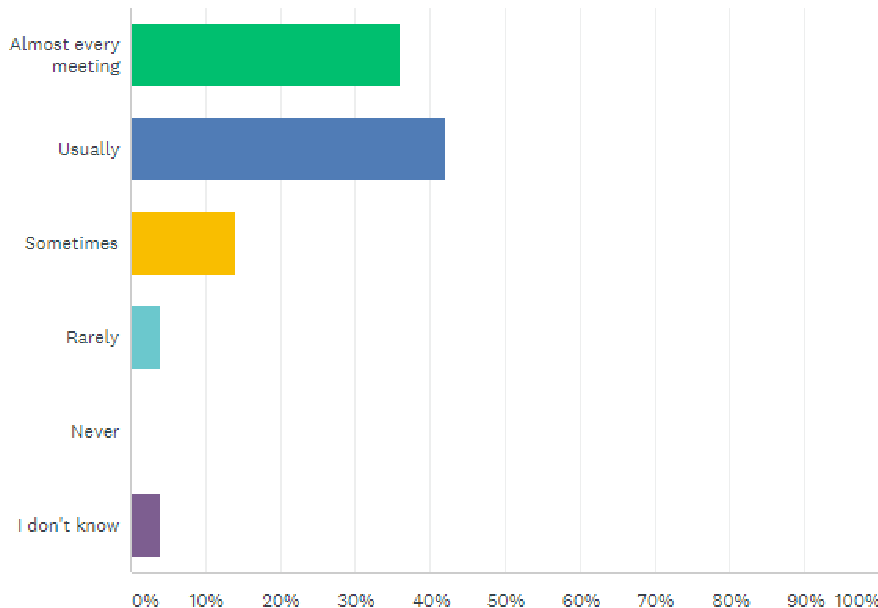
Steadily increasing demand from investors and society at large for ESG considerations to be incorporated into investment products and processes

Investors are seeing increased demand from their end-investors and society at large for investment products which take account of ESG considerations. Additionally, increasing societal awareness of environmental and social challenges is shaping consumer behaviour, with significant implications across sectors. The resulting change in consumer behaviour will materially impact the future company performance and therefore needs to be taken into account in any investment with a medium-term time horizon.

As their end clients increasingly seek more granular detail on ESG topics, like a portfolio's overall carbon footprint, investors will need to receive this data from companies. According to our ESG Investor Survey conducted in November 2019, though which 100 investors submitted their views on ESG investing, almost 90% reported fielding questions from their end-investors on ESG "usually" or "at almost every meeting".

[6] MiFID2: draft delegated directive, to amend the MiFID Commission Delegated Directive ((EU) 2017/593) as regards the integration of sustainability factors and preferences into the product governance obligations.
[7] UCITS: draft delegated directive, to amend the UCITS Commission Directive (2010/43/EU) as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS).
[8] AIFMD: draft delegated regulation, to amend the AIFMD Delegated Regulation ((EU) 231/2013) as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers.
[9] MiFID2: draft delegated regulation, to amend the MiFID Commission Delegated Regulation ((EU) 2017/565) as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.

ELFA Investor Survey: "How often do you get questions from investors on ESG?"

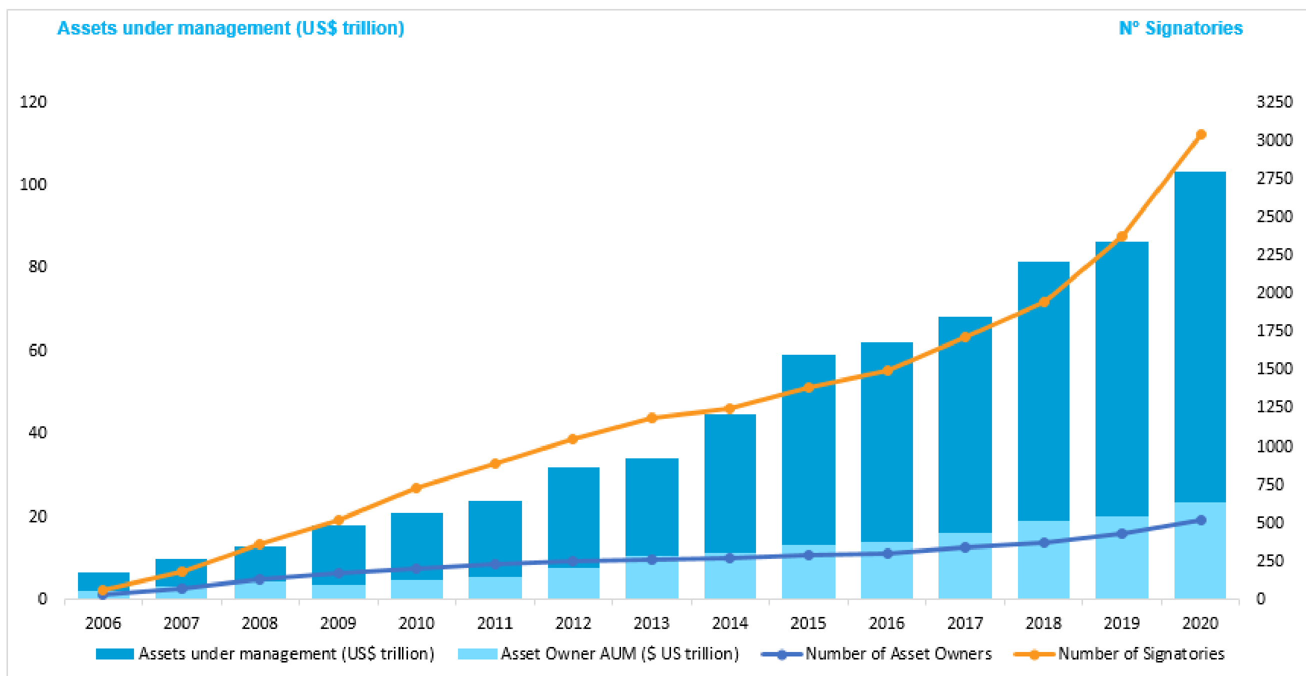


Further, to the extent that companies provide this information, investors can screen-in those with comprehensive disclosure as they will be equipped to conduct holistic fundamental and non-fundamental work. In addition, as investors increasingly seek to "green-up" their portfolios, they will look to invest in companies that provide the relevant disclosure necessary to further this objective.

The rising growth and popularity of ESG investing is well illustrated by the increasing number of signatories to the Principles for Responsible Investment (PRI), established in 2005 and supported by the United Nations. To date, over 3,000 investment organisations, representing over US$103 trillion, have signed up to the PRI.

According to Morningstar data[10], investors continued to pour in capital in sustainable funds during 2020, as Q2 saw record fund inflows, despite the ongoing pandemic. Assets in European sustainable funds rose a remarkable 20% in Q2 to €774 billion, compared with an increase of just 11% for the overall European fund universe. This data suggests that the COVID-19 crisis has further reinforced the importance of building sustainable and resilient business models.

PRI Signatory growth



[10] https://www.morningstar.co.uk/uk/news/204525/sustainable-fund-flows-hit-record-in-q2.aspx

Incorporating ESG data and information into company offering materials and period reporting has several potential benefits.

The following benefits could be derived from including ESG information in company offering materials and periodic reports:

- **Investor confidence:** Leveraging off an existing, established process and that all parties are familiar with and trust will provide investors with confidence that the ESG information has undergone an adequate level of due diligence
- **Timely information:** Investors would have access to the information when they need it, with data refreshed during the new deal process, which is a typical trigger for investor ESG requests
- **Mechanism for updates:** Periodic reporting cycles provide a mechanism for the information to be refreshed
- **Market consensus:** Reaching consensus on the scope of a core set of ESG disclosure topics and associated metrics by way of the ELFA ESG Fact Sheet would provide the market with a minimum basis for ESG disclosure, facilitating a level of standardisation within the industry
- **Consistency among borrowers:** Disclosure in offering materials and periodic reports provide a common reference point for ESG disclosure and creates a level playing field for all borrowers in the market. It also provides a foundation to build additional proactive, public ESG communication such as on a corporate website and/or stand-alone ESG reporting
- **Avoiding selective disclosure:** If companies are reporting directly to investors without seeking advice from counsel, there is a risk they may inadvertently disclose material information to some investors, but not others, potentially giving rise to liability.

Whilst the measures suggested above would not fully eliminate ad-hoc investor ESG information requests to borrowers, the ELFA believes it would materially reduce the volume of investor requests. Just as borrowers currently respond to individual investor requests relating to information in financial statements, which is driven by each investor’s analysis and specific points, we believe that the market would benefit from a similar approach to ESG disclosure.

By providing the market with a foundation for a minimum level of sector-focused information, we believe that the quality of engagement between investors and borrowers on ESG topics will improve significantly. Indeed, we hope that the dialogue will move beyond basic facts to more business-relevant ESG subject matter, positioning borrowers to better engage with investors and reap the opportunities that a more progressive ESG approach can bring.

About the European Leveraged Finance Association

The European Leveraged Finance Association (ELFA) is a professional trade association comprised of European leveraged finance investors from over 30 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA website: www.elfainvestors.com.

Our Mission Statement:

The ELFA seeks to create a more transparent, efficient, and resilient leveraged finance market while acting as the voice of its investor community. To that end, our diverse forum of investors engages with other industry professionals in order to educate and to promote best practices and transparency.