European Leveraged Finance Association

INSIGHTS

1 March 2022

Climate in Focus for Leveraged Finance Investors: Perspectives from ELFA's Climate Workshop

ISSUE #25

Inside this issue...

1 March 2022

Climate in Focus for Leveraged Finance Investors: Perspectives from ELFA's Climate Workshop

Executive Summary

- November 2021 was ELFA Climate Month, aligned with COP26, during which we held discussions with market participants across various events and prompted insightful dialogue on obstacles to integrating and analysing climate risk at the firm, portfolio, and investment levels.
- One such event was our Climate Workshop that aimed to facilitate discussions amongst investors about how they are integrating climate risk into their credit analyses, and to understand how they are implementing commitments to net zero at a firm and portfolio level.
- Nearly forty participants shared their experiences, knowledge and contributed concrete suggestions for next steps on this topic for the industry.
- Participants were split into three breakout groups: high yield bonds and broadly syndicated loans (BSLs), private credit and CLOs.
- For high yield bonds and BSLs, participants expressed the need to have both qualitative and quantitative climate change risk data that can be aggregated at the portfolio level to better facilitate reporting to stakeholders.
- In private credit, data collection efforts are reportedly in development at the borrower and industry level, but more work is yet to be done to further grow ESG investing in this market. ELFA is collaborating with the efforts of the ESG Data Convergence Project.
- In the CLO market, investors are particularly keen to gather climate information at both the portfolio level and the loan level, given the reliance on the underlying corporate portfolio inherent in the structure of CLOs. Importantly, for some CLO investors, a CLO manager's ESG credentials make up 50% of the investor's overall ESG assessment of a new CLO transaction.
- In this report, we highlight key findings from the workshop to enable the wider market to benefit from the input and insights exchanged during the event.

Introduction

With the UK hosting the 26th UN Climate Change Conference (COP26), ELFA dedicated the entire month of November as ELFA Climate Month to align our focus with leaders, to discuss the accelerating action to tackle the global threat of climate change, and to shed light on the tools and resources that can help with this challenge.

Results from our recent ELFA 2021 ESG Investor Survey, also held in November, clearly highlighted an increased focus on climate change risk assessments in the leveraged finance market.

As part of our continued efforts to support the growth of ESG investing, ELFA held a Climate Workshop for members as part of ELFA Climate Month. During the workshop, participants discussed the steps that firms are taking to assess climate change risks at the firm, portfolio, and investment level. Participants also explored additional challenges that firms face in the leveraged finance market when tackling climate related topics, particularly in relation to data collection and analysis.

This report contains highlights from discussions held during the breakout group sessions, with participants split based on asset classes: high yield bonds and broadly syndicated leveraged loans (BSLs), private credit and CLOs.

Key Insights on Climate Change Risks Highlighted by ELFA's 2021 ESG Investor Survey Results include:

- 57% of survey respondents indicated that climate change risk is extremely or very important in their credit analyses. To conduct these analyses, respondents use data from internal research, information gained from borrowers in response to ELFA ESG Fact Sheets and bespoke questionnaires, or from external data providers.
- 73% of respondents are increasingly being asked by their end-investors about portfolio-level climate change risk data, including carbon emissions data and to what extent their portfolios are net zero-aligned.
- According to 8% of respondents, questions about climate change are explored at nearly every investor meeting; another 32% of respondents usually receive such questions, whilst 33% sometimes receive such questions.
- More survey results can be found here.

High Yield Bonds and BSLs

ELFA's ESG Investor Survey results found an increased focus on climate change risk assessments in the leveraged finance market. Qualitative information currently dominates in the high yield bond and BSL markets, given the relative dearth of quantitative data, although this is gradually improving.

Rapid progress in overall ESG disclosure

Workshop participants noted that tremendous progress has been made in the European leveraged finance market with respect to ESG data in the last 18 to 24 months, including climate change risk data. This has been supported by ELFA's ESG Fact Sheets, which set out key ESG topics for 13 individual sectors (plus one sector-agnostic ESG Fact Sheet) and which were recently updated to facilitate the reporting of more quantitative data.

Qualitative ESG information is increasingly disclosed by borrowers. As a natural next step, investment managers are looking for more objective and quantifiable data that can be aggregated at the portfolio level (and at the firm level) for aggregate analysis and to report to stakeholders, such as end-investors and regulators.

Increased – and potentially overemphasised – focus on carbon emissions data

Participants in the high yield bonds and BSL workstream noted that currently there may be an undue focus on carbon emissions. End-investors and regulators prioritise obtaining carbon emissions data and there are various factors driving this trend:

- carbon emissions are a global focus and are relatively easy to understand;
- the data are numeric and therefore can be more easily and objectively tracked, measured, and reported;
- the data are directly linked to the Paris Agreement and countries' net-zero pledges;
- third-party providers tend to collect such data; and
- existing reporting frameworks include carbon emissions among key data requirements, such as the EU SFDR and TCFD frameworks[1] and the recently introduced UK FCA's climate-related disclosures for asset managers, life insurers and FCA-regulated pension providers.

However, participants expressed concern that carbon emissions data may become the sole focus for investors and borrowers, risking overshadowing other essential ESG information which may not receive the attention that it should.

"Carbon data is not necessarily the most important number as there can be more significant ESG areas or weaknesses at a company" – Investor

[1] In 2017, the Financial Stability Board's Taskforce for Climate-related Financial Disclosures (TCFD) published its recommendations for climate-related financial disclosures. More details can be found here: https://www.fsb-tcfd.org/. See Appendix for further detail on both the EU SFDR and TCFD carbon data requirements.

Further, according to some investors, merely providing the quantitative data is not sufficient. Workshop participants noted that they would like to understand the context and measurements behind the number, as this can be just as important as the number itself.

Portfolio aggregation and carbon offsets present challenges to asset managers

ELFA members participating in the Climate Workshop indicated that LPs regularly request aggregated portfolio data from investment managers, which create significant challenges for investment managers given a backdrop of scant levels of information reported by borrowers.

Measuring the carbon footprint of a portfolio is difficult, if not impossible, when not all borrowers disclose this data. Even where the data is disclosed, borrowers may not do so in a consistent, comparable or timely manner within individual sectors, let alone across myriad sectors. Asset managers are forced to make estimations where gaps exist. Climate Workshop participants also emphasised the value of assessing the trajectory in emissions rather than looking at the data in isolation.

Climate Workshop participants also noted that they are aware of the use of carbon offsets and are keen to understand why and how they are being used by borrowers. Leveraged finance asset managers seek transparency in disclosure, for example, distinctions between net and gross emissions data.

Private credit

Private debt lenders are still in the process of establishing data collection processes in the sector, whether qualitative or quantitative. Data was therefore one of the main discussion points amongst participants in the private credit workstream.

Data availability hampers climate change risk analysis

Currently, information gathering is achieved primarily through sending bespoke questionnaires to borrowers.

Some participants in the private credit workstream engage third party specialists for data collection and climate change risk analysis, for example to measure, estimate and/or monitor a borrower's carbon footprint.

"As part of the DDQ, data on ESG is always completed now and this wasn't the case even six months ago" – PE Sponsor

Workstream participants also discussed how climate change risks can generally be divided into two categories: physical risks and transition risks.

- Physical risks can either be acute (e.g., increasingly severe weather events) or chronic (e.g., desertification). One investor explained that their firm hired a consultant to assess the climate change risks facing a particular business. One of the physical risks assessed by the consultant involved identifying whether any of the company's major operations or suppliers were near coastal areas and therefore exposed to flooding risk, which could impact the insurability of the business or cause logistic disruptions.
- Transition risks accompany a borrower's transition to a low-carbon economy, and can be further divided into policy and legal, technology, market and reputation risks. For transition risk assessment purposes, the consultant helped quantify the cost of carbon and the cost of transitioning for the company.

ESG Data Convergence Project

Participants discussed the ESG Data Convergence Project, an industry initiative lead by private equity GPs and LPs in coordination with other market participants, including private credit lenders. The initiative seeks to align the market toward a standardised set of six initial ESG metrics. The six metrics are:

- Scopes 1 and 2 greenhouse gas emissions,
- Renewable energy,
- Board diversity,
- Work-related injuries,
- Net new hires, and
- Employee engagement.

For the 2021 calendar year, GPs have been tracking and reporting these six metrics in a standardised format for their portfolio companies. The data are then aggregated into an anonymised benchmark by Boston Consulting Group and shared directly with invested LPs. This collaboration aims to increase the quality, availability, and comparability of ESG data in private markets.

TCFD reporting and net zero-alignment

According to private credit workstream participants, efforts to report in line with the TCFD framework and net zero-alignments[3] are hampered by data availability issues, both in the private credit market and in the leveraged finance market more broadly.

One aspect of TCFD reporting is the carbon footprinting of investment portfolios, which is already a challenge in the high yield bond and BSL asset classes, and even more so within private credit. Some investors noted that their firms signed up to the TCFD reporting framework, whilst others are using the recommendations for internal reporting and scenario analysis without formally signing up to the reporting framework.

Given the current lack of data, investors are also concerned that setting targets and metrics as per the TCFD recommendations may be particularly challenging in the private credit market. Net zero-alignment is on private debt investors' minds; however, data availability makes meaningful net zero-alignment difficult to achieve at this stage.

CLOs

In the CLO workstream, participants expressed a desire to gather both loan level and portfolio level information, given the structure of CLOs and the reliance on the underlying corporate portfolio.

The complexity of the CLO asset class amplifies data collection issues

Workshop participants noted that as CLO investors they have limited influence on the extent of ESG data disclosure by the underlying borrowers. Beyond data availability, investors seek standardisation of data to enable investors to aggregate information at the portfolio level.

[3] Pledges to reach net-zero GHG emissions by 2050.

Given the general lack of data, including with respect to climate change risks, participants discussed the significant challenges to conducting climate change risk analysis on CLOs. Participants hope to encourage CLO managers to track such data, including carbon emissions, for the purpose of disclosing such data to their CLO investors.

ESG credentials of CLO managers are of increasing importance

Some CLO investor workstream participants noted that 50% of their internal ESG assessment on a new CLO transaction comes from their ESG assessment of the CLO manager itself, since the actively managed nature of these vehicles results in significant influence by the CLO manager.

To gather information for this assessment, CLO investors send ESG questionnaires to CLO managers to assess ESG credentials. These questionnaires collect information not only about the CLO manager's corporate social responsibility, but also their ESG approach to investments and ESG criteria embedded within CLO documentation. In 2021, ELFA collaborated with the LSTA and the LMA in developing the CLO Manager ESG Diligence Questionnaire, which CLO investors are increasingly using.

"We are surprised at the difference in managers – some have a passion and some don't care." – Investor

Continued engagement on climate data is necessary across leveraged finance asset classes

Whilst the discussions at our Climate Workshop provided significant value to participants through the exchange of experience and knowledge amongst ELFA members, many questions remain. We intend to continue these discussions through various forums to support engagement across the industry. We will also continue to support industry initiatives and further develop our own resources to reflect the evolving needs of leveraged finance investors across the high yield bond, BSL, private credit and CLO markets.

Appendix

TCFD Framework: Common Carbon Footprinting and Exposure Metrics[4]

Weighted average carbon intensity (WACI)	Measures a portfolio's exposure to carbon-intensive assets, expressed in tons CO2e/$M revenue. This is a metric recommended by the Taskforce.
Total carbon emissions	The total absolute greenhouse gas emissions attributable to a portfolio, expressed in tons CO2e
Carbon footprint	Total carbon emissions for a portfolio normalised by the market value of the portfolio, expressed in tons CO2e/$M invested.
Carbon intensity	The volume of carbon emissions per million dollars of revenue (carbon efficiency of a portfolio), expressed in tons CO2e / $M revenue.
Exposure to carbon-related assets	The amount or percentage of carbon-related assets. in the portfolio, expressed in $M or percentage of the current portfolio value.

EU SFDR, draft Regulatory Technical Standards as per 2 February 2021

Mandatory climate and other environment-related adverse sustainability indicators – now captured in the ELFA ESG Fact Sheets

- Greenhouse gas emissions: scope 1, 2 and 3 emissions and total emissions
- Carbon footprint
- GHG intensity of investee companies
- Share of investments in companies active in the fossil fuel sector
- Share of non-renewable energy consumption and production
- Energy consumption intensity per high impact climate sector
- Activities negatively affecting biodiversity-sensitive areas
- Emissions to water
- Hazardous waste ratio

[4] https://www.tcfdhub.org/Downloads/pdfs/E09%20-%20Carbon%20footprinting%20-%20metrics.pdf

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 50 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The 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's website: www.elfainvestors.com.

European Leveraged Finance Association
35 Ballards Lane, London N3 1XW
T +44 (0)7921 384457
E support@elfainvestors.com

European Leveraged Finance Association