

# CLO Carbon and Climate Disclosures: Methods for Enhancing Transparency

ISSUE #39

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# CLO Carbon and Climate Disclosures: Methods for Enhancing Transparency

## Executive Summary

The need for more consistent carbon and climate disclosures within CLO transactions is set to step up rapidly due to regulatory and market developments. While ESG integration increased significantly in the past 24 months, with most CLO managers adopting negative screening and incorporating ESG factors in their investment process, developing a consistent and transparent carbon and climate reporting increases the pressure on CLO managers to obtain GHG emissions and other relevant data from borrowers.

This guidance publication outlines:

- Carbon disclosure is affecting participants through the entire CLO value chain, from asset owners, CLO investors, and CLO managers to corporate borrowers, all with their own part to play in promoting carbon and climate disclosure.
- Carbon and climate disclosure goes beyond reporting; understanding the climate risks and their implications on investments becomes increasingly important for CLO and loan investors alike.
- The intensifying regulatory pressures around carbon and climate disclosures is impacting all market participants directly or indirectly. This guidance provides a practical summary of regulations and immediate, as well as potential, future impact on CLO investors and other market participants.
- Carbon and climate metrics, while well-established and defined, vary significantly in their complexity to measure and implement. The report is structured to provide practical reporting guidance across absolute metrics, such as total financed emissions, and economic-intensity metrics, which include carbon footprint and weighted average carbon intensity.
- This report then expands into carbon reduction and climate risk metrics, focusing on climate value at risk, implied temperature rise and use of the SBTi framework.
- The guidance describes the practical challenges of calculating and disclosing these metrics and provides high-level description and useful links for further exploration.
- In the final section, the guidance outlines further developments, summarising the next generation of requirements, moving beyond climate.
- These include potential risks, such as ecosystem impact and innovation risk, amongst others, embedded in CLO portfolios and their double materiality.
- The guidance also outlines social factors and provides details on norms-based and value-based screening frameworks.

This publication is a result of a collaborative effort, bringing together ELFA members' expertise from across ELFA's ESG Committee, Loan Investor Committee and CLO Investor Committees. Although this report widely refers to CLOs, CLO managers and CLO investors, it is directly relevant to any type of loan fund, fund manager and fund investor.

## Introduction – The Need for More Consistent CLO Climate Disclosures

Investor demand for ESG integration within CLOs has increased significantly in the past 24 months, resulting in most CLO managers introducing negative screening and incorporating ESG factors into their investment processes. In particular, investor focus on climate disclosures within CLO transactions is set to further step up rapidly, due to regulatory and market developments. This increases pressure on CLO managers to obtain GHG emissions reporting and other relevant data from borrowers. In addition, understanding emerging sources of climate-related credit risk and addressing these through active management is becoming increasingly crucial for CLOs.

Both European and US CLO asset managers have a vested interest in enhanced data transparency at the underlying borrower level and a consistent methodology for reporting GHG emissions at the portfolio level. The approach presented in this report can be implemented by European and US CLO managers. Uniformity in reporting would facilitate deal and asset manager assessments for global CLO investors.

Although this report widely refers to CLOs, CLO manager and CLO investor, it is directly relevant to any type of loan fund, fund manager and fund investor.



## The CLO Value Chain Will Create Growing Pressure for Disclosure – Aligning with Stakeholder Expectations is Key

### Value Chain and Climate Disclosure – Downwards Pressure on Borrowers

<b>Asset Owners</b>	<ul style="list-style-type: none"> <li>Asset owners such as pension funds and insurers are under similar pressure as asset managers to disclose climate impacts, both from beneficiaries and regulators (e.g. the UK Department for Work and Pensions climate disclosure requirements).</li> <li>Many invest directly in CLOs and will be seeking this information from transactions.</li> <li>An increasing number are also seeking this information from their asset managers.</li> </ul>
<b>Asset Managers</b>	<ul style="list-style-type: none"> <li>CLO investors consider GHG emissions data within their CLO investments as part of their financed emissions, which can be a component of investors' manager assessment or trigger engagement with managers on climate topics.</li> <li>CLO investors are increasingly required to disclose financed emissions, engagement, and target-setting activities in relation to climate change, for example under the UK Financial Conduct Authority's TCFD reporting requirements.</li> <li>Asset class coverage will shift for most from a 'best efforts' basis to comply or explain in 2024 – compelling many to seek detailed climate data from CLO managers.</li> </ul>
<b>CLO Managers</b>	<ul style="list-style-type: none"> <li>CLO managers are under growing pressure to demonstrate their ESG credentials to investors, reflected in the substantial rise in activity-based ESG exclusion criteria and increased focus on integrating ESG factors into their investment processes.</li> <li>Some CLO investors are currently considering carbon and climate reporting as a prerequisite for investment in European CLOs, regardless of whether the CLO manager falls within the scope of regulatory disclosure requirements.</li> </ul>
<b>Borrowers</b>	<ul style="list-style-type: none"> <li>Operational and value chain GHG emissions provide a valuable source of information on climate-related risks to a company's overall business model, opportunities for emissions reduction and performance improvement, and are increasingly important from a market access perspective as climate-focused investors seek this information.</li> <li>The higher borrowing costs incurred by these corporates should (in theory) mean that market access is a priority, so better climate data reporting by borrowers should increasingly represent an opportunity.</li> </ul>

Historically, the default rate for CLOs is significantly lower than similarly rated corporate bonds and loans. Nonetheless, because underlying loans drive returns, market credit spread movements can lead to price impacts. Another key risk is credit rating migration (rating agency downgrades, for example as a result of structurally higher regulatory compliance costs as seen in the automotive sector from climate and air emission policies).

If the loan portfolio deteriorates, this could lead to downgrades of the debt liability tranches, leading to underperformance of the CLO transaction. Capitalising on opportunities within the CLO market relies on active management, including bottom-up research on individual loans, underlying borrowers and associated credit risks.

Transitional climate risks can present both immediate and long-term credit risks to companies, to which highly leveraged CLO borrowers are acutely sensitive. These can include:

- **Rising regulatory compliance costs** (for example, carbon allowances for industrials or tightening vehicle emissions standards)
- **Increasing raw material and energy input costs that can erode profitability** where these costs cannot be passed on.
- **Shifting demand for goods and services**, creating opportunities for some companies and challenges for others
- **Risk of asset stranding** as older assets may increasingly become unviable with tightening emissions standards.

It is important to stress that there are also upsides to the low-carbon transition – and companies that are able to demonstrate positive momentum on emissions could increasingly be able to secure more favourable refinancing and loan terms.

### Key Regulatory Drivers for Climate Disclosure by CLOs

CLO managers can increasingly expect to be required to report climate data. Whilst most managers themselves may not fall within the scope of existing named regulations, CLO investors are looking to satisfy their own or align with their clients' sustainability reporting obligations when investing in CLOs subject to carbon and climate diligence and reporting standards. CLO investors are therefore under significant pressure to quantify the environmental and social impact of their investments.

For example, pension schemes reporting under TCFD will have to show scope 3 (financed emissions) data pertaining to the climate impact of their portfolio investments. If they have mandated an asset manager for their investments, they will usually require the data from the managers to comply with carbon and climate reporting requirements.

### Why Managers and Investors Should Care About Climate Risk

On the surface, climate risks would appear to be less material for CLO investors than for other asset classes such as high-yield corporate debt because of the significant diversification and built-in risk protections. Yet, climate risk is one of many relevant issues for managers to consider – both from a reporting perspective and from a portfolio construction perspective.



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Similarly, under the EU Sustainable Finance Disclosure Regulation (SFDR), UK-based asset managers who manage European funds will have to comply with carbon reporting even though CLOs and other securitised assets are not a “financial product” covered by the SFDR rules.

European supervisory authorities have clarified that where the investee company is a Special Purpose Vehicle, managers should look through the underlying collateral when assessing metrics such as GHG emissions. For CLO investments, this entails looking at the data from the underlying leveraged loans.

## Key regulations, outline, and practical implications for CLOs

<b>UK FCA TCFD Reporting Requirements</b>	<p>The TCFD (Task Force on Climate-related Financial Disclosures) – is a market-led set of recommended climate-related disclosures for corporates and financial institutions including metrics such as scope 3 emissions which started as voluntary guidelines and are now becoming part of mandatory regulatory framework in many jurisdictions. The companies in scope include large premium listed companies, asset owners, life insurers and FCA regulated pension providers and asset managers.</p> <p>FCA-authorized asset managers with AUM of over £5bn are required to publish entity and product-level reports detailing a range of climate metrics, including emissions performance. In practice, whilst many CLO managers will likely be out of scope of the regulations, UK-based CLO investors may request that managers prepare entity or product-level TCFD reports with respect to their CLO business and transactions. As a result, managers may increasingly be required to demonstrate TCFD alignment by clients without a formal legal requirement to do so.</p> <p>For UK-domiciled asset managers, initial product and entity-level TCFD disclosures began in June 2023 on a ‘best efforts’ basis. From 2024, this will shift to a ‘comply or explain’ model so asset class coverage is expected to sharply increase.</p> <p>In addition to the UK, a number of other jurisdictions are in the process of implementing mandatory TCFD-aligned disclosure requirements, including Australia, New Zealand, Singapore, Canada, Japan and South Africa.</p>
<b>International Sustainability Standards Board – IFRS S2 Climate-Related Disclosures</b>	<p>The International Sustainability Standards Board (ISSB) under the aegis of the IFRS Foundation has recently issued its first two global standards for corporate ESG disclosures. IFRS S2 is effective for annual reporting period beginning on or after 1 January 2024, with earlier application permitted as long as IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information is also applied. IFRS S2 focuses on climate-related disclosures and is fully aligned with the TCFD disclosure recommendations. Because of the wide use of IFRS standards (with 132 jurisdictions requiring IFRS aligned disclosures), this is expected to be adopted by member countries as part of national disclosure requirements.</p> <p>ISSB Standards fully incorporate the recommendations of TCFD, further standardising and mainstreaming climate reporting.</p>
<b>SEC Proposed Climate Disclosure Rule</b>	<p>The US Securities and Exchange Commission (SEC) proposals for standardised climate disclosures (Scope 1 &amp; 2, and where relevant, Scope 3 emissions, i.e. if either of two conditions are present: a) if Scope 3 emissions are material to the company or b) if the company has set an emissions target or goal that includes Scope 3 emissions) will be a key driver of more comparable disclosures on GHG emissions from corporates and thus more meaningful data on which to base investment decisions. The rule is expected to be issued by 31 October 2023, mandating disclosure of Scope 1&amp;2 emissions by large companies in 2025 and medium-to-small companies in 2026 and 2027, respectively. All companies bar smaller firms will be required to disclose Scope 3 emissions after an initial annual report.</p>
<b>EU Corporate Sustainability Reporting Directive</b>	<p>CSRD (Corporate Sustainability Reporting Directive) - The Non-Financial Reporting Directive (NFRD) will be replaced and expanded upon by the CSRD which came into force in January 2023 for a broader set of large companies and listed SMEs to report on certain environmental and social factors. The CSRD has staggered implementation dates which are dependent upon type of entity. In the meantime, the NFRD legislation remains in place for large companies in scope.</p> <p>The EU CSRD entered into force in 2023 and represents a significant increase in the scope of mandatory ESG reporting. Whilst initially applying to companies listed on regulated markets in the EU and large companies of over 250 employees, the regulation will be expanded to small-to-medium enterprises and to non-EU companies with a net turnover of EUR150 million in the EU, and with at least one subsidiary or branch in the union, over the next three years, and for investors will form the basis of EU Taxonomy and SFDR reporting.</p> <p>A key distinction from other initiatives such as the SEC rule and ISSB is the focus on so-called double materiality (financial and non-financial risk and impact factors) within disclosures.</p>
<b>EU Sustainable Finance Disclosure Regulation</b>	<p>The SFDR (Sustainable Finance Disclosure Regulation) is an EU regulation which applies to financial market participants and financial advisors within the EU, including asset managers, institutional investors, insurance companies, and pension funds, and sets the disclosure process of sustainable information, such as the integration of sustainability risks and the consideration of adverse sustainability impacts.</p> <p>The rapid growth of ESG screening criteria in CLO transactions in the past two years has coincided with the introduction of the EU Sustainable Finance Disclosure Regulation (SFDR). Although formally a disclosure regime, SFDR has become a de facto fund labelling system.</p>



## Where to Start – Carbon Reporting Metrics

Emissions data can be disclosed by companies through standard ESG questionnaires and diligence forms such as the ELFA ESG Fact Sheet,<sup>1</sup> the ESG IDP Questionnaire,<sup>2</sup> the Carbon Disclosure Project (“CDP”), or the company’s annual sustainability report. Several ESG data providers offer products and services that aggregate company level emissions data, which managers may subscribe to for ease of access. The Initiative Climate International (iCI) has also developed guidance<sup>3</sup> for private companies and their lenders on climate disclosure.

In the absence of company reported emissions data, managers may use physical activity data such as total electricity consumption (GWh), location of the company’s headquarters, offices, and manufacturing sites, and fuel consumption (e.g., litres, gallons) to estimate emissions.

Managers are encouraged to actively engage with companies to consider emissions reporting to help identify relevant value-creation projects such as energy savings and waste reduction initiatives. Several ESG data providers also provide various estimated emissions metrics and tools that managers may also subscribe to.

We encourage CLO managers to ensure robust understanding of the data provider’s methodology and data integrity before integrating the metrics into diligence and investor reporting. Additionally, industry frameworks such as the Partnership for Carbon Accounting Financials (“PCAF”) Guidance provides helpful guidance for consistent security level financed emissions calculation that would be applicable for the CLO manager.

## Need for Transparency

Albeit improving, reported emissions data within the loan markets remain limited. As a result, most CLO managers incorporate a mix of estimated emissions data and reported emissions data. To the extent estimated emissions data is used, whether it was calculated and sourced from a third-party data provider or conducted in-house by the CLO manager, the proportional split between reported and estimated data within the portfolio should be disclosed to investors to uphold transparency. Additionally, all underlying methodologies, sources of data, as well as the timing of the data points used for emissions and financials should also be disclosed.

There are several ways of disclosing the underlying quality of the aggregated CLO emission, including percentage breakdowns of reported vs estimated information. The use of industry reporting standards such as PCAF

provides a quantitative metric where the quality of emissions data is ranked from 1 – 5 Data Quality Score (1 representing reported data with company financials and most preferred; 5 representing estimated data using asset turnover ratio with industry average emissions and least preferred).

Portfolio level weighted average indicators such as the PCAF Data Quality Score can also provide a consistent metric for investors to monitor and compare. When providing aggregated CLO financed emissions metrics, all underlying methodologies and sources of data should be disclosed.

## Key Carbon Metrics: Description and Calculations

Aggregate portfolio level GHG emission metrics can be broadly categorized into: absolute metrics, economic-intensity metrics, and physical-intensity metrics. Each offer different insights into the portfolio’s emissions and serve as a comparability tool for investors.

Absolute metrics helps managers and investors understand the climate impact of underlying investments and allow for a baseline establishment for climate action. Economic-intensity metrics helps managers and investors understand how the emission intensities of different portfolios (or parts of portfolios) compare to each other per monetary unit. This allows CLO managers to identify any emissions “hot spots” to inform borrower engagement priorities.

We highlight the most commonly used metrics for credit portfolios and how these metrics can be used by CLO managers and investors. In addition, we provide a numerical example on how to aggregate data for a stylistic portfolio of four loans across three different borrowers and where carbon emission data is only available for Borrower 1 and 2. For simplicity we are only showing Scope 1+2 emissions but the methodology followed should be the same for Scope 3 and Total emissions aggregates.<sup>4</sup>

Please note that Carbon Emissions aggregated at CLO level are agnostic to market value metrics of loans in the collateral portfolio. Also, please note the stylistic example below is for illustration purposes only. The order of magnitude for these metrics for a typical EUR 400million balance sheet CLO of a diversified pool of loans is expected to be in the following ranges: Total Carbon Emissions Scope 1+2 circa 30,000 tCO<sub>2</sub>e; Carbon Footprint circa 100 tCO<sub>2</sub>e/M EUR and WACI circa 120 tCO<sub>2</sub>/M EUR).

<sup>1</sup> <https://elfainvestors.com/publications/elfa-diligence/>

<sup>2</sup> <https://www.esgidp.org/>

<sup>3</sup> <https://www.unpri.org/news-and-press/initiative-climat-international-issues-guidance-to-encourage-measurement-of-greenhouse-gas-emissions/11783.article>

<sup>4</sup> Please note that PCAF guidance requires reporting entities to disclose scope 3 emissions for select sector exposures (transportation, construction, buildings, materials, and industrial activities) starting in 2023 and all sectors starting in 2025. Reporting entities must explain if they are not able to disclose scope 3 financed emissions information due to lack of data availability or uncertainty. CLO managers should be mindful of these requirements when measuring and reporting in alignment to PCAF.



## Where to Start – Stylistic CLO Portfolio Calculated Examples

Loan ID	Borrower ID	Current Face value (M EUR)	Px	Market Value (M EUR)	GHG Scope 1+2 emissions (tCO <sub>2</sub> e per year)	Revenue (M EUR)	Enterprise Value (M EUR)	Source
1	1	80	98%	78	1,400.00	1,300.00	16,000.00	Third-party
2	1	100	95%	95	1,400.00	1,300.00	16,000.00	Third-party
3	2	120	98%	118	60,000.00	12,600.00	24,000.00	Estimated
4	3	60	95%	57				No data available
Cash		30						NA
<b>Total</b>		<b>390</b>	<b>97%</b>	<b>376</b>				

	Metric & Brief description	Unit	Calculation		
Data Transparency	<b>Data Transparency Breakdown</b> CLO AUM “Financed” Emissions= Sum of borrower current face value with emissions data, therefore excluding cash or borrowers current face value where the CLO manager doesn’t have carbon emission data	Millions of EUR and as percentage of total CLO AUM	Data disclosure	Current Face Value	% of CLO AUM
			Third party	180 MEUR	=180/390=46.15%
			Collected by desk	0 MEUR	
			Estimated	120 MEUR	=120/390=30.77%
			CLO AUM “Financed” Emissions and Coverage (%)	=180+120=300 MEUR	=300/390= 76.92%
			CLO AUM	390 MEUR	
Absolute Metrics	<b>GHG Scope 1+2 financed emissions</b> = Sum of security-level GHG Scope 1+2 financed emissions. “Security-level GHG Scope 1+2 emissions” need to be weighted by the current face value of the investment per million EUR of Enterprise value (attribution factor)	Metric Tonnes of CO <sub>2</sub> equivalents (tCO <sub>2</sub> e)	GHG Scope 1+2 Emissions= (Borrower 1 GHG Scope 1+2 Emissions*Attribution factor) + (Borrower 2 GHG Scope 1+2 Emissions*Attribution factor) = Borrower 1 GHG Scope 1+2 Emissions *(Sum of Borrower 1 loan current face value/Enterprise Value Borrower 1) + Borrower 2 GHG Scope 1+2 emissions*(Sum of Borrower 2 loan current face value/Enterprise Value Borrower 2) =  <b>For a stylistic portfolio above the calculation will look as follows:</b> 1,400 tCO <sub>2</sub> e*((80+100 MEUR)/16,000 MEUR)+60,000 tCO <sub>2</sub> e*(120 MEUR /24,000 MEUR)= 15.75 + 300 = 315.75 tCO <sub>2</sub> e		
	<b>Carbon footprint Scope 1+2</b> = “GHG Scope 1+2 financed emissions” divided by CLO AUM “Financed” emissions in millions of EUR	Metric Tonnes of CO <sub>2</sub> equivalents (tCO <sub>2</sub> e)/ EUR million invested	Scope 1+2 Carbon Footprint= GHG Scope 1+2 Emissions/CLO AUM “Financed” Emissions  <b>For a stylistic portfolio above the calculation will look as follows:</b> 315.75 tCO <sub>2</sub> e / 300 MEUR= 1.05 tCO <sub>2</sub> e/MEUR invested		
Economic Emission Intensity Metric	<b>Weighted Average Carbon Intensity (“WACI”)</b> = Weighted average of absolute company level emissions divided by company yearly revenue (revenue- based intensity) = Weighted average of company level carbon emissions intensity	Metric Tonnes of CO <sub>2</sub> equivalents (tCO <sub>2</sub> e)/ EUR million Revenue	Weighted Average Carbon Intensity (“WACI”)= (Borrower 1 loan current face value/CLO AUM “financed” Emissions) * (Borrower 1 GHG Scope 1+2 Emissions/Borrower 1 Revenue) + (Borrower 2 loan current face value/CLO AUM “financed” Emissions) * (Borrower 2 GHG Scope 1+2 Emissions/Borrower 2 Revenue)  <b>For a stylistic portfolio above the calculation will look as follows:</b> ((80+100)MEUR /300 MEUR)*(1,400 tCO <sub>2</sub> e/1,300 MEUR)+(120 MEUR /300 MEUR)*(60,000 tCO <sub>2</sub> e/12,600 MEUR)= 0.65 + 1.90 = 2.55 tCO <sub>2</sub> e/ MEUR of revenue		



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## What Next – Carbon Reduction and Climate Risks Metrics

Whilst the asset management community is firmly focused on improving the availability of data and disclosure of current GHG emissions associated with the investment portfolios, it is important to highlight the next level of metrics and calculations that will be needed to either satisfy further regulatory disclosure requirements or are demanded by asset owners to assess how their capital allocations are consistent with their own 1.5°C net zero emissions pathway.

This section highlights these additional metrics and calculations, providing high level descriptions, guidance, and useful links. We also describe the practical challenges relating to calculation and disclosure of these metrics in relation to investment portfolios.

In its recent handbook publication,<sup>5</sup> the UK FCA outlined other elements of TCFD reports that firms must, as far as reasonably practicable, include in fund disclosure of climate related financial information, namely climate value-at-risk and climate warming scenarios with which investment funds are aligned to.

## Climate Impact Metrics

The UK FCA has outlined the requirement to report metrics that show emissions intensity, absolute emissions and the climate warming scenario with which an investment portfolio is aligned, for example using implied temperature rise (“ITR”) metric.

Weighted average carbon intensity (absolute emissions divided by annual revenue) and carbon footprint metrics (absolute emissions divided by enterprise value) are widely reported in comparison to benchmarks. Investors generally view these metrics as the most useful for portfolio construction and target setting.

Additionally, ITR metrics estimates the global temperature rise associated with GHG emissions of a single entity or a selection of entities (for example those in a given investment portfolio, such as a CLO collateral pool). ITR is expressed in a single temperature unit or a range that is comparable to widely understood potential climate outcomes (for example 1.5°C, 2.0°C, 3.5°C etc). Numerous publications<sup>6</sup> are available to guide asset managers in developing climate warming assessment of their investment portfolios.

While reporting ITR on investment portfolios will provide asset owners with the most direct measure of how their capital allocations are aligned with their own net zero targets and appreciating the challenges in computing such measure, other frameworks have been broadly adopted by the financial industry to further climate transition disclosures related to assets in investment portfolios.

## Science Based Targets Initiative (“SBTi”)

One of the ESG metrics adopted and recommended<sup>7</sup> by Investment Consultants Sustainability Working Group (“ICSWG”) is the disclosure of the number and proportion of companies within the investment portfolio with SBTi-verified targets in place.

The SBTi,<sup>8</sup> founded in 2015, is a partnership between CDP, the United Nations Global Compact, World Resources Institute (“WRI”) and the World Wide Fund for Nature (“WWF”) and it provides companies with a clearly-defined path to reduce emissions in line with the Paris Agreement goals. More than 4,000 businesses around the world are already working with the Science Based Targets initiative to develop and officially certify their own science-based plans and targets to reducing greenhouse gas emissions.

Through direct engagements, asset managers can proactively encourage investee companies to commit to setting a science-based target. Typically, this will focus on companies in the highest-emitting sectors, which play a crucial role in ensuring the transition to a zero-carbon economy.

## Climate Value-at-Risk

Physical and transition risks related to climate change are well advertised and can potentially lead to idiosyncratic and systemic risk within the financial sector as well as opening new investment opportunities.

Climate Value at Risk (“CVaR”) metrics are designed to provide forward looking assessment of climate related risks and opportunities in investment portfolios. In computing CVaR, several variables can be incorporated, including but not limited to:

1. Variables related to transition risks such as policy scenarios and technology developments.
2. Variables related to physical risks, including extreme weather scenarios and hazards, such as flooding and wildfires, with potential to impact companies’ physical assets as well as operations.
3. More traditional financial variables such as total revenue and diversity of revenue sources by location and market coverage.
4. As well as broad economic indicators related to jurisdictions where investee companies operate.

Numerous publications<sup>9</sup> can guide asset managers in developing their own frameworks to measure CVaR of their portfolios. Alternatively, third party provider services are available, however asset managers should consider the applicability of proposed frameworks as well as coverage of assets within their investment portfolios.

Reporting CVaR on CLO collateral portfolios will then allow CLO investors to incorporate these measures in their own investment portfolios on a look-through basis.

<sup>5</sup> <https://www.handbook.fca.org.uk/handbook/ESG.pdf>

<sup>6</sup> <https://www.fsb.org/wp-content/uploads/P291020-4.pdf>

<sup>7</sup> [https://www.icswg-uk.org/\\_files/ugd/9624a9\\_12e6622be8e14cbd8f4b12b3b31caf80.pdf](https://www.icswg-uk.org/_files/ugd/9624a9_12e6622be8e14cbd8f4b12b3b31caf80.pdf), <https://www.icswg-uk.org/resources>

<sup>8</sup> <https://sciencebasedtargets.org/>

<sup>9</sup> <https://www.unpri.org/pri-blog/assessing-climate-risks-in-investors-portfolios-a-journey-through-climate-stress-testing/5526.article>



## Further development – Aspirational Measures

ESG integration in investments began with the analysis of the impact of environmental, social and governance factors on companies, focusing heavily on financial materiality. However, the focus of regulators and asset owners has increasingly shifted from single materiality which assesses the climate-related impacts on the company to the concept of ‘double materiality’ which also considers the impacts the company has on the climate and wider society.

The EU taxonomy<sup>10</sup> helps investors determine whether an economic activity is environmentally sustainable and meets robust standards that are consistent with policy commitments. The EU Taxonomy has focused on six environmental objectives which include (1) climate change mitigation, (2) climate change adaptation, (3) sustainable use and protection of water and marine resources, (4) transition to a circular economy, (5) pollution prevention and control, and (6) protection and restoration of biodiversity and ecosystems.

Due to (i) the urgency of climate change and its global impact, (ii) established priorities and climate neutrality by 2050, and (iii) the complexity of such taxonomy, the EU initially focused on the climate-related environmental objectives. Whilst eligible projects for the remaining objectives have yet to be codified in EU law, the Platform on Sustainable Finance has published a detailed report and annexes encompassing 60 economic activities in 12 sectors.

## Moving beyond climate

Although the EU has not yet announced the timeline for finalizing the remaining objectives in regulation, ELFA and CLO investors are anticipating the next generation of requirements required by SFDR.

In a world where understanding credit risk is just not enough, CLO investors need to have a view on the risks imbedded in portfolios and their double materiality, such as:

**Ecosystem impact of a portfolio** – in addition to climate impacts, there are other concerns including the limited supply of natural resources, increasingly fragile ecosystems and the high levels of waste generation. An estimated 15% of global gross domestic product is highly dependent and 37% moderately dependent on nature, with some economic sectors and activities fully dependent. Financial risks linked to water stress are increasing, with almost two-thirds of all freshwater resources going into corporate supply chains. The ELFA ESG Fact Sheets cover many of these topics.

**Innovation risks** – it is also critical to understand KPIs (away from carbon) for business risks. CLOs invest in companies which are highly competitive and sometimes cyclical. Innovation, globalisation and market pressure create many opportunities and threats for the underlying borrowers that need to be raised at a CLO level. We understand that CLO

managers are aware of these risks and capture them in their credit underwriting, but such measures will provide an average sensitivity of the portfolio.

**Reputational risks** – these KPIs at a CLO level also gives an estimation of the portfolio exposure to reputational risks. Aside from environmental risks, social and governance risks are also material for example lawsuits and conflicts can impact a business’s reputation. The double materiality of KPIs is significant in this instance.

**Financial risks** – areas of water stress are increasing and companies are the world’s largest water users, with almost two-thirds of all freshwater resources going into corporate supply chains, from food to chemicals.

**Regulatory risks** – there are many ongoing projects trying to regulate environmental interaction and social integration. Assessing materiality started with the introduction of the TCFD framework assessing climate-related opportunities and risks, but various stakeholders have asked for increased disclosure around how companies address new sustainability themes such as biodiversity, water stress and waste management. Similar to the TCFD framework, the TNFD (“Taskforce on Nature-related Financial Disclosures”) is expected to release its full framework for market adoption in September this year to help organisations report and act on nature-related risks and opportunities.

## UNGC and OECD screens and Social Factors

### Norms-based screening: UNGC and OECD

A growing number of investors are aligning their responsible investment approach to include norms-based screening based on frameworks such as the UN Global Compact and the OECD Guidelines for Multinational Enterprises. These represent the world’s foremost voluntary corporate responsibility initiatives. The Global Compact<sup>11</sup> asks companies to enhance, support and enact, within their sphere of influence, a set of core principles in the areas of human rights, labor standards, the environment and anti-corruption. The two initiatives are based on complementary premises – the OECD Guidelines<sup>12</sup> cover some areas that are not covered explicitly by the UN Global Compact. The guidelines cover chapters on disclosure, consumer interests, science and technology, competition, and taxation.

### Value-based screening: Social Factors

While norms-based exclusions have been one way to approach screening, investors also seek to exclude certain sectors, issuers or securities based on specific ESG criteria. One such social factor that investors want to reduce their exposure to is controversial weapons which restrict investments in companies involved in the manufacture or selling of controversial weapons.

The social component of ESG typically focuses on all the ways that companies interact with their employees, customers and stakeholders including the communities in which they operate. Similar to the green taxonomy, the EU hopes to develop a similar platform to drive investments to address social issues through the establishment of a social taxonomy. The idea behind the social taxonomy is to help investors play a role in contributing to the realization of human rights, such as improving access to quality healthcare or ensuring decent jobs.

Another social factor that has risen on the investor agenda is Diversity, Equity, and Inclusion (DEI) and one area where we have seen significant progress is investor pressure resulting in more diverse boards.

<sup>10</sup> [https://finance.ec.europa.eu/system/files/2022-03/220329-sustainable-finance-platform-finance-report-environmental-transition-taxonomy\\_en.pdf](https://finance.ec.europa.eu/system/files/2022-03/220329-sustainable-finance-platform-finance-report-environmental-transition-taxonomy_en.pdf)

<sup>11</sup> <https://unglobalcompact.org/>

<sup>12</sup> <https://www.oecd.org/corporate/mne/>





9 October 2023

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### About ELFA:

ELFA is a professional trade association comprised of European leveraged finance investors from over 60 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 ELFA's website: [www.elfainvestors.com](http://www.elfainvestors.com).

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