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How Is ESG Regulation Influencing Investor Behaviour?

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Environmental, social, and governance (ESG) considerations have become a hot topic in the global debt capital markets, particularly since the pandemic. Though the securitization market has been slower to adapt to this trend, largely in part due to the complex nature of the market, investor interest in ESG is growing and the securitization market is fast evolving across products, such as asset-backed securities and residential and commercial mortgage-backed securities, with increasing green, social, and sustainability issuance. Many deals refer to the International Capital Market Association's green, social, and sustainable principles or the United Nations Sustainable Development Goals.

ESG considerations have been prioritized, largely driven by investor demand, over the last few years. Investors want more information and data around ESG, recognizing that the topic presents a serious, if not existential, risk to the business models they are investing in, rather than a 'nice to have' element. In a report issued in April 2021, Citigroup Inc. stated that 20–40% of U.S. collateralized loan obligation (CLO) managers will incorporate ESG factors into new issue CLOs in 2022 and 2023, propelled by growing demand from investors. This projection is up from 11% in 2020 and a mere 3% in 2019. The sustainable revolution is growing apace, and as a result, many fund managers have amended their existing investment strategies or, in some cases, launched new ones to address these pressures and also, particularly in Europe, to address the requirements of the EU Sustainable Finance Disclosure Regulation (SFDR). But this movement is not just in Europe – it is important globally; and whilst most changes are occurring in Europe, investors are also monitoring other regions such as APAC and the United States.

In some respects, this trend can be distilled into two words: 'risk management'. As ESG has become an increasing issue for credit quality, and financial market stakeholders and investors have identified a growing number of ESG-related risks, the question has been asked as to how such ESG risks may be measured and how are financial market stakeholders and investors increasingly trying to reduce their exposure to such ESG risk in the products they invest in.

But as well as risk management, it is clear that such demands are also underpinned by a desire to have a more positive environmental and societal impact. However, a word of caution is needed here as many investors report that right now, ESG issues do not impact whether an investment is made, particularly in relation to CLOs, when ESG factors are viewed as tail-risk events rather than forming a part of day-to-day investment decisions. This area, though, needs further examination, particularly given the rise of ESG post pandemic.

As a result of these trends, the convergence between ESG and securitized products in the capital markets (whilst still in its infancy) is evolving rapidly, and as a result there has been a marked rise in ESG provisions in the CLO market, due in large part to the pressure investors have and are now exerting.

The CLO Market

CLOs are the biggest buyers of leveraged loans – a key source of financing for private equity buyouts – which they repackage as floating-rate securities. Issuance, including new issue, refis, and resets, in the U.S. hit a record of roughly $107.5 billion in Q121, up 169% from Q120. In Europe, new CLO issuance totaled €7.8 billion in Q121 – a 35% year-on-year increase and the best quarter for new issuance since Q219. The year-on-year improvement in CLO resets (which reprice the debt in existing portfolios and extend deal reinvestment periods) and refinancings (which maintain maturities but lower the spreads payable to investors) was even more profound. European CLO refinancings totaled €8.3 billion in Q121 versus none in Q120, while resets increased to €9.8 billion from only €790 million over the same period in 2020. Analysts now expect resets and repricings for 2021 to massively exceed initial forecasts, reflecting continuing demand from investors matched with the continuing strong supply. Both are due to the 2020 backlog, which is now further boosted by the short one-year non-call deals from 2020 that are coming online for refinancing. Morgan Stanley now estimates up to €50 billion of CLO resets and refinancings in the European market in 2021, up from the €15–20 billion estimate in its 2021 outlook, as investors adjust to reflation by purchasing more debt that will benefit if yields rise.

About 44% of outstanding European CLOs now include ESG criteria. Although the U.S. still lags behind Europe in incorporating ESG criteria, U.S. CLOs are joining the ESG trend. According to recently published BofA CLO research, more than 70 U.S. CLO managers are now signatories to the UN Principles for Responsible Investment, and the indentures for more than 200 recently priced CLOs have included negative screening criteria.

Unlike corporate bonds, however, loans have been slow to embrace ESG, hindered by a lack of data on the borrowers. Globally, loans that are labelled 'green' represent a very small chunk of all sustainable issuance. Lending to leveraged companies rarely includes terms predicated on clearly defined ESG benefits, and the companies are often backed by private equity sponsors, which themselves may have an image problem when it comes to ESG impact. But this is changing. In Europe, particularly in the sustainability-linked loan market, companies have started to include incentives or key performance indicators (KPI) – known as ratchets – in loan documentation to, for example, reduce borrowing costs if defined sustainability goals or KPIs are met.

Negative to Positive Screening?

ESG and CLOs have been converging since the emergence of ESG negative screening in 2019. Globally, CLOs tend to approach ESG through a negative screening process, overseen by the CLO manager, by outlining certain non-ESG-friendly industries (typically based on a certain percentage of revenues) that they are prohibited from investing in as part of the 'collateral obligation' definition. Such industries or sectors include not only tobacco products (which have long been excluded from CLO portfolios), but increasingly also arms, gambling, thermal coal production, pornography, payday lending, oil and gas speculation, hazardous chemicals, opioids, palm oil, and marijuana. Negative screening of non-ESG-friendly industries poses several challenges to CLO managers, not least the vagueness of the prohibitions that frequently require management discretion. For example, while 'hazardous chemicals' are prohibited by several CLOs as part of the ESG screening, the nature of the hazard is rarely defined, and it is not clear whether this includes only producers of banned chemicals or whether portfolio managers have to judge that all chemicals are dangerous at some level and so avoid the sector entirely. Further challenges come from legal documentation accompanying CLO issuance not being harmonized; there is no standardized approach to incorporating ESG considerations into CLOs.

As a result, some CLO managers are afforded more flexibility than others, even across deals that purport to prohibit the same industry or activity. With this documentation backdrop, CLO managers' ESG evaluation processes remain vague, and – for now – little price differential exists between ESG CLOs and other mainstream products.

Negative screening exploded in 2021 to the point of ubiquity with ESG negative-screening provisions in European CLO new issuances and resets. This year has seen further changes for ESG provisions in CLOs, with forward-thinking managers introducing subjective ESG scoring across CLO portfolios and the emergence of objective ESG reporting on CLO assets and information about what happens when an obligor becomes non-ESG compliant. This is especially the case in the sustainability-linked loan (SLL) market, which has developed more ESG components within products within the SLL and high-yield bond market.

As the proportion of leveraged loans that include ESG-related elements increases globally, CLO managers may soon be able to adopt language that pushes for the positive inclusion of sustainable or sustainability-linked assets, which are becoming increasingly prevalent across the global markets. This would represent a shift where CLOs move to a system of positively screening for assets with ESG components for inclusion in their portfolios, rather than negatively screening for prohibited industries. This will mean that in just two years, from 2019 to 2021, we will have moved from a small number of leveraged borrowers making ESG commitments to perhaps a majority of leveraged primary issuance in 2021 containing ESG covenants. This startling acceleration of ESG in the non-investment-grade market, together with the SFDR and the demand from the bond market, paves the way for CLOs to positively commit to minimum ESG portfolio concentrations, potentially leading to CLOs with whole portfolios of these ESG products.

Regulatory Pressures

In addition to risk management and a positive environmental and societal impact, regulation is a factor that is also becoming increasingly important among the drivers behind more systematic ESG incorporation. The first provisions of the EU sustainability-related disclosures in the SFDR came into force in March 2021 as part of the EU Commission's policy focus on sustainable finance and of the EU's ambition to be climate-neutral by 2050. Broadly, the SFDR applies to a broad range of financial market participants and aims to increase transparency and prevent 'greenwashing' by requiring enhanced disclosure of ESG products. Although these regulatory changes are being spearheaded in Europe, their repercussions will have a wider reach because all financial market participants wanting to operate in the EU will have to comply.

Further regulatory movement in Europe comes from the EU taxonomy for sustainable activities – a classification system establishing a list of environmentally sustainable economic activities – and the European Union is also working towards an EU green bond standard. In the United States, regulatory movement comes from the new Biden administration and its recommitment to the Paris Agreement; the Green New Deal proposals in Congress; the SEC's request for public input from investors, registrants, and other market participants on climate change disclosure; and the Commodity Futures Trading Commission establishment of a new climate risk unit.

The SFDR imposes a heavy compliance burden; it requires financial market participants, including investment managers, to disclose certain information about (1) how they integrate sustainability risks into their investment decision-making process; and (2) whether (and, if so, how) they take into account principal adverse impacts of investment decisions on sustainability factors. At the product level, it requires them to disclose how they consider the principal adverse impacts which investee entities may have on sustainability factors. Whilst the SFDR does not impact CLO issuers directly, to the extent that EU-based CLO managers are credit institutions or investment firms, they are likely to fall within the long reach of the SFDR because they provide portfolio management services.

When a financial product promotes ESG characteristics or objectives broadly (known as Article 8 funds or a 'light green' product) or has sustainable investment as its objective (known as Article 9 funds or a 'dark green' product), disclosures have to include information on how those characteristics or objectives are to be met. These products also must comply with reporting effective from January 2022. Further details of the disclosures and reporting forms will eventually be set out in regulatory technical standards, which are yet to be finalized. This is likely to remain a discussion point until more clarity has been provided.

At present, the UK has not implemented the SFDR into its domestic law. It is therefore likely that many UK-based managers of European CLOs will be outside the jurisdictional scope of the SFDR. However, the main objective of the SFDR is for harmonization – the EU believes the financial sector has a vital part to play in achieving the EU's sustainable development goals. We therefore would expect that non-EU managers will seek to comply with reporting provisions equivalent to those set out in the SFDR that may well result in an increase in CLOs structured as Article 8 funds under the SFDR. Indeed, Article 8 funds are already investing in CLOs and, through time, we could see CLOs marketed as Article 8 funds (with the prospect of Article 9 CLOs to follow).

Conclusion

We have seen evidence of more sophisticated data analysis being employed for assessing ESG performance, and ESG-screening (both negative and now increasingly positive) is fast becoming the norm for many products. There are still a number of challenges ahead, not least of which is the need for more information to be delivered in a more harmonized and standardized way. The greatest challenge remains overcoming the lack of adequate data to conduct ESG due diligence so that investors can begin systematically integrating ESG factors in their securitized products analysis. To overcome this challenge, it is clear that as the markets adapt to such demands and mature, there needs to be cooperation to achieve a holistic, multipronged approach at an industry level that can provide harmonized and standardized data and information.

Once this happens, the growth of ESG CLOs should continue into the near and medium term, since it is clear that the call from investors for CLOs to embrace ESG is just too loud to ignore. Investor demand for ESG-related investments is not going away, and it is expected that these will only increase as demographics, public opinion on social and justice issues, the aftermath of the COVID-19 pandemic, and climate change continue to evolve, especially as the world is gathering at COP26 and there is a more of a focus on climate change than ever before. The CLO markets are perfectly placed to embrace these developments, and we should expect more ESG CLOs focusing on sustainable sectors such as infrastructure, renewables, and clean energy – solar, wind, and electric.

It took some 13 years to 2020 to print the first $1 trillion of sustainable bonds. It took just one more year in 2021 to double that. Think about that….

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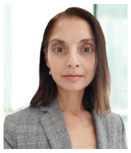

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