CLOS - THE NEW FRONTIER OF ESG INTEGRATION IN FIXED INCOME MARKETS

Imane Kabbaj, head of sustainable investment specialists, explores the origins of ESG in CLOs, how ESG integration in CLOs evolved overtime, how Carmignac integrates ESG in CLOs and what the future looks like.

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The past decade witnessed a flurry of innovation and developments in the sustainable debt space: from the creation of new instruments such as sustainability linked bonds (SLBs)/ transition bonds/ blue bonds, etc. to the establishment of new standards such as ICMA guidelines and the EU Green Bonds Standards, and finally, the increased sophistication of ESG integration in fixed income strategies and bondholders' engagement. GSSS+ debt (Green, Social, Sustainable, Sustainability-linked bonds and others) reached a record cumulative issuance of $5tr[1] in early 2024. Against this backdrop, and broader acceptance of the important role fixed income markets can play in a sustainable investment portfolio, the question of the contribution of collateralised loan obligations (CLO) has arisen.

With approximately 33% of the distributed securitised credit market[2], more than $1tr of the corporate financing markets and 70% of US corporate loans in H1 2024[3], CLOs have slowly moved from a niche asset to a prominent player in the fixed income markets offering attractive yields to investors.

ESG INTEGRATION IN CLOS

HOW DOES IT WORK?

The emergence of ESG characteristics in CLO documentation can be traced back to 2018; it initially focused on exclusionary criteria such as firearms and gambling.

Although there are currently no regulations or standards mandating ESG disclosures in CLOs, data shows it has slowly become common industry practice, with over 90% of European CLOs now including some ESG language in their documentation[4]. This trend has been magnified by the advent of SFDR regulation in 2021; whereby ESG language has become a quasi-permanent fixture in the European CLOs documentation.

Looking at a sample of CLO disclosures, our analysis shows that exclusions typically relate to the following sectors: controversial weapons, tobacco and thermal coal, etc; which is aligned with industry best practice for other asset classes.

HOW HAS IT EVOLVED?

As CLO issuance continued to reach new highs (~$51bn in 2023 and ~$98bn as of H12024 and on track for a new record by the end of the year)[5], so too did the sophistication of ESG integration.

This started with the increased participation of CLO managers in prominent industry initiatives such as UN PRI; of which roughly 54% of US & EU CLO managers are now signatories[6]. The adherence to such industry initiatives came hand in hand with the increased formalisation of CLO managers' ESG policies, as well as an increase in resources dedicated to ESG assessments and ESG due diligence.

The most advanced CLO players have also started including ESG scoring/rating in the extra-financial analysis component of their investment process.

HOW IT IS DONE AT CARMIGNAC?

Our investment team analyses the ESG characteristics of CLOs, as a part of their investment process, including:

- Negative and/or positive screening, which may include: the exclusion of controversial sectors (tobacco, weapons, thermal coal production, etc.), the carbon intensity of the issuers of the underlying assets, and human capital policies, etc
- Look-through analysis by assessing the securitisation vehicle's underlying assets
- ESG analysis of the manager of the securitisation vehicles
- Direct engagement & escalation with the CLO manager/issuer to improve the ESG characteristics of the securitised instruments

The ESG analysis results in a rating for each instrument in START, our proprietary ESG research platform, on a scale of A to E (with A representing the 'best' score). This informs our universe reduction and security selection process.

WHAT'S NEXT?

Although the integration of ESG in CLOs has accelerated, the path ahead will depend on the asset class's ability to overcome its existing challenges; primarily the lack of ESG data/disclosures, and more broadly, the lack of a standardised framework.

At the time of writing, there are no SFDR Article 9 CLOs in the market. This is mainly due to the limited pool of leveraged loans that could satisfy the sustainable investment criteria; but also due to the existing gap in ESG integration at the leveraged loan level (which is still dependent on the underlying private equity sponsors). As issuance and the ESG integration in private equity investment processes and frameworks increase; so would the chances to have this type of products which often constitutes the pinnacle of sustainability for an asset class.

To unlock the full potential of ESG in CLOs, collaboration between various parties such as CLO managers/issuers, private equity firms, leveraged finance originating banks, industry bodies and regulators is paramount. This will not only help CLOs play a larger role in sustainable debt overall but could also help demystifying securitised products.

[1]Environmental Finance data 2024.

[2]HSBC data; 2024.

[3]BOFA CLO data 2024.

[4]S&P Global research

[5]Barclays Research data: July 2024.

[6]LSEG data May 2024; based on a sample of 187 CLO managers.

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