Look deeper to uncover ESG performance in CLOs

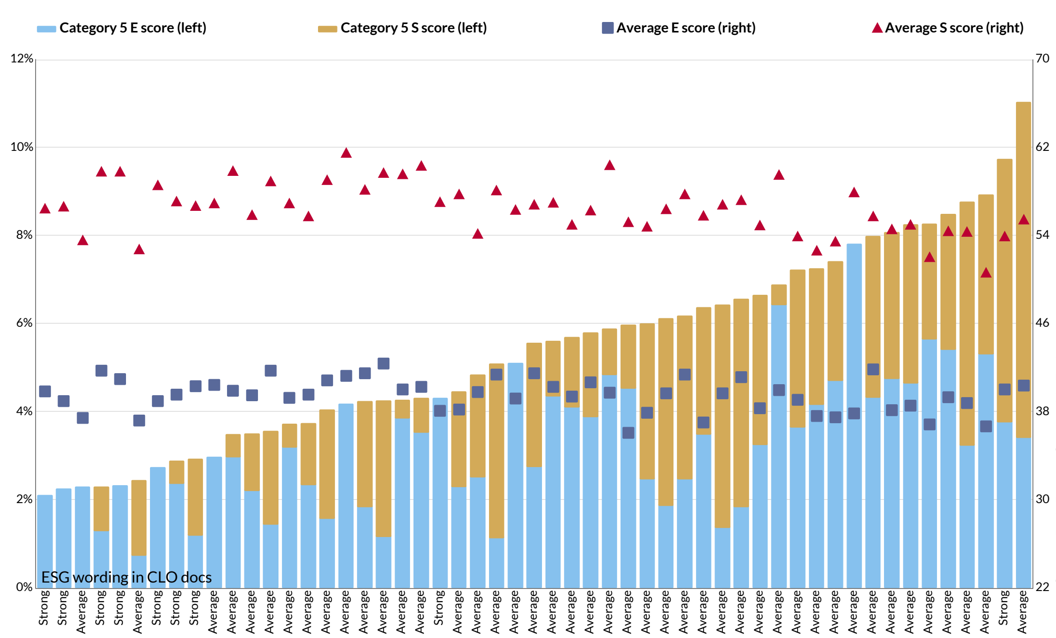
New research from Fitch Ratings, which examines ESG Score analysis from Sustainable Fitch, examines how European CLOs are performing on ESG criteria and has confirmed that the wording in documentation really does make a difference — but only if you look below the surface.

This study was based on data gathered for Sustainable Fitch's ESG Scores for Leveraged Finance, which provides scoring for each of the underlying assets in CLO portfolios, covering over 500 individual assets in the European CLO market. It looked at the portfolios of 53 European CLOs rated by Fitch that closed in 2022, comparing the weighted average aggregate E and S sub-scores of their underlying collateral. There was very limited exposure to credits with poor governance (G) in this cohort of European CLOs so the focus was on environmental (E) and social (S) scores.

At first glance, the results showed good news for the European CLO market. Thanks to advances in CLO documentation in the European market, all deals performed well when looking at weighted average E and S sub-scores. In fact, there was very little variation across the vintage — all the deals had average environmental scores between 36 and 42, and average social scores between 51 and 61.

As Vincent Scalvenzi, senior director, structured credit, at Fitch Ratings points out, "You have to remember that the European leverage loan market is relatively small so you see a high overlap in names. When you focus on exposure to the weakest assets that's when you start to see differentiation between CLO portfolios."

E&S sub score for EMEA CLOs closed in 2022



> **Exposure to the weakest assets is where you see differentiation between European CLO portfolios**
>
> *Vincent Scalvenzi, Fitch Ratings*

But that uniformity breaks down when you look below those average scores to the proportion of category-five assets — the weakest band (see methodology box overleaf).

The exposures to those category-five names showed pronounced variations across the 53 CLOs, with average exposures running from just 2% of credits to more than 10%. The results are even more pronounced when looking only at category-five social exposure, which ranged from no exposure to almost 8% of the portfolio.

What is driving this somewhat hidden variation in how well European CLOs are doing on their ESG? There was a strong correlation between exposure to these weakest ESG names and the ESG wording in CLO documentation. As previously mentioned, all the European CLOs examined had at least some features like negative screening and some due diligence.

A smaller group of just nine CLOs had what Fitch Ratings deemed to be "strong" wording, which included either ESG scoring by the CLO managers, frequent ESG reporting for investors, due diligence, ESG eligibility criteria, or a concept of a minimum average ESG score for the CLO.

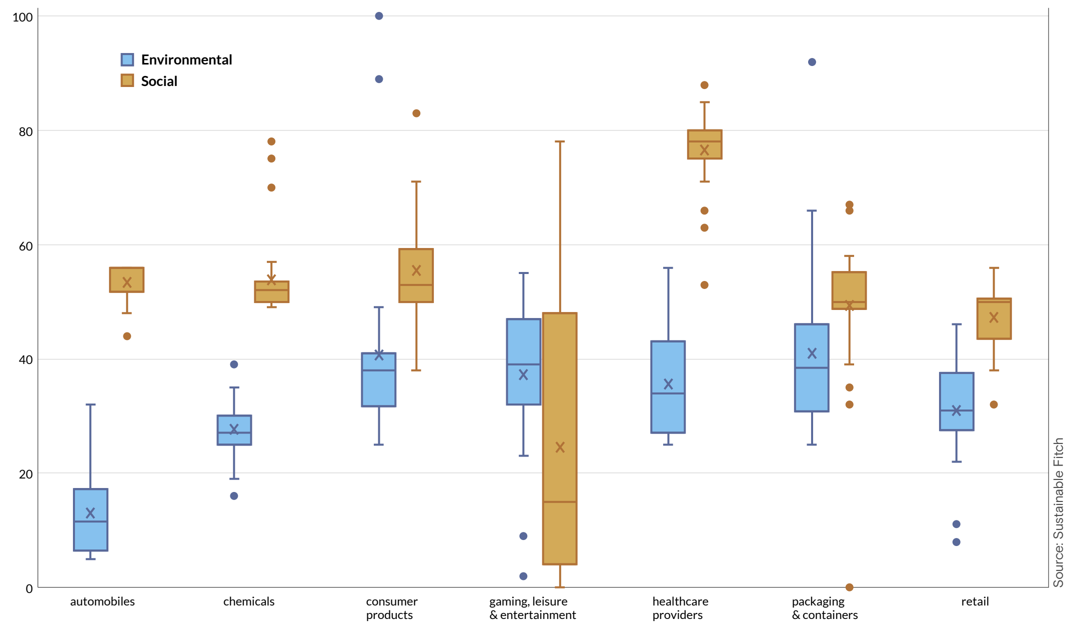
Perhaps unsurprisingly those nine CLOs had very limited category-five exposure (with one notable exception), occupying seven out of the 10 deals with lowest exposure. What is more surprising is that when looking at average scores for the whole portfolio, it would be difficult to find any statistically significant bonuses for strongly worded ESG language, at least for the European CLO market. More details for the factors contributing to these discrepancies can found in an industry breakdown.

It should be noted that the Sustainable Fitch ESG scores for leveraged loans that drove this study are based on information extracted from syndication documents and do not involve input from issuers. Investors (and managers) who need more detailed analysis, or scoring on private assets, can request that as part of a separate service from Sustainable Fitch.

What conclusions can be drawn? Firstly that the European CLO market was getting a lot of things right by 2022. All of the 53 CLOs analysed had at least negative screening of certain industries and some due diligence, and by weighted average ESG scores are making advancements. But the value of more strongly worded CLO documentation is also clear when looking at exposure to the most problematic credits, especially in the gaming, leisure and entertainment sectors.

For additional information on the Sustainable Fitch ESG Scores for Leveraged Finance, please contact esgscoreslf_investors@sustainablefitch.com

E&S scores distribution for selected industries EMEA



METHODOLOGY

- Sustainable Fitch's ESG Scores for leveraged finance are asset level, granular, short-form proprietary ESG assessment products, and provide an indication of an entity's business alignment with an aggregate score, as well individual environmental, social and governance aspects.
- ESG scores are on an absolute scale that ranges from 0 to 100, which allows comparability across and within industries. Scores are also divided into five categories. Category-five names are the weakest, with scores from zero to 12.5.
- This study was based on the 53 European CLOs rated by Fitch that closed in 2022. The data includes ESG scores available as of 10 March 2023 and portfolio holdings as of the latest investor reports.
- Average ESG Score coverage was 96% of the notional amount of these portfolios.
- Average E and S scores are based on a notional amount and only for EMEA CLOs closed in 2022.
- Exposure to category-five E and S values are based on the percentage of the portfolios, notional based.

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