

C A D W A L A D E R

Greening CLOs - The Growing Market for Sustainable Securitisations

Presented by: Michael Sholem, Claire Puddicombe & Alex Collins

4 November 2021

OVERVIEW

- SFDR and CLOs
- The EU Taxonomy Regulation
- Legislative initiatives for sustainable securitisations
- “Green” CLOs
- ESG divergence between the US, UK and EU
- Investor requirements and disclosure challenges

“The transition to a low carbon economy will also bring its own risks and opportunities...Firms that align their business models to the transition to a net zero world will be rewarded handsomely. Those that fail to adapt will cease to exist. The longer that meaningful adjustment is delayed, the greater the disruption will be.”

Mark Carney, Governor of the Bank of England, October 8, 2019

“This is Europe’s man on the moon moment...Our goal is to reconcile the economy with our planet.”

Ursula van der Leyen, EC President, December 9, 2019

SFDR and CLOs (1)

A recap on the Sustainable Finance Disclosure Regulation

- Environmental, social and governance (“**ESG**”) disclosures became mandatory for financial advisors and financial market participants (“**FMPs**”) e.g., asset managers, banks, pension funds, insurance companies, etc. in the EU (as well as non-EU fund managers marketing their products in the EU).
- Two sets of obligations / disclosures:
 - Entity level (at level of the FMP / financial advisor)
 - Product level (at the level of the financial product) – “Article 8 and Article 9 products”
- The disclosure requirements relate to:
 - Integration of sustainability risks
 - Principal adverse impacts of investment decisions on sustainability factors
 - Specific templates are required for **pre-contractual disclosures**, disclosures on **websites**, and disclosures in **periodic reports** in relation to financial products
- Joint Committee of the ESAs published draft Regulatory Technical Standards (RTS), on the content, methodologies and presentation of disclosures, including draft templates, on **4 February 2021**. These templates were not applicable at the go live date of **10 March 2021**.
- On **8 July 2021**, the European Commission announced that these disclosure standards will be delayed by six months from **1 January 2022 until 1 July 2022**.

SFDR and CLOs (2)

- Entities covered by the SFDR, depending on the nature of their activities, must comply with the rules where they manufacture and promote *financial products*, and with the rules on financial advisers where they provide investment or insurance advice.
- “Financial product” is defined at Article 2(12) of the SFDR and includes: an AIF; an IBIP; a pension product; and a pension scheme or a UCITS. It also includes a portfolio managed by a MiFID portfolio manager. The definition does not include shares or debt securities.
- A CLO collateral manager may well be carrying on MiFID portfolio management, but its client (to whom the “financial product” is being provided) is the issuer only.
- Extra-territorial impact on UK and US authorised collateral managers?
- Lack of direct application has stirred UK and EU authorities to consult on a new “sustainable securitisation” regime

The EU Taxonomy Regulation

- Creates a unified classification system on what constitutes an “environmentally sustainable” activity.
- To qualify, an activity must:
 - make a substantive contribution to one or more of the six objectives;
 - do no significant harm to the other five objectives;
 - meet minimum OECD and UN safeguards; and
 - comply with technical screening criteria to be developed.
- Applies to:
 - FMPs;
 - “*Financial products*”
 - Large corporates subject to the NFRD; and
 - EU Commission and Member State governments when setting standards (e.g., EU GBS).

Environmental Objectives under the Taxonomy Regulation:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable water use and marine protection
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

Legislative initiatives for sustainable securitisations

In summer 2021...

- EBA survey on sustainable securitisation
- HM Treasury: Call for evidence on the UK Securitisation Regulation
- European Commission: Targeted consultation on the functioning of the EU Securitisation Framework

Key themes:

- What kind of ESG information should be required to be disclosed and how to obtain this from obligors?
- Templates for disclosure vs. principles
- Consistency across asset classes
- An STS style regime? What are the incentives to make a transaction ESG compliant?

“Green” CLOs

- Distinct from CLOs in the market that rely solely on negative screening criteria.
- Enhanced ESG due diligence:
 - prior to acquisition; and
 - on an ongoing basis.
- ESG Score:
 - asset by asset basis; and
 - weighted average portfolio basis.
- Positive role in restoring ESG compliance.
- ESG-specific reporting.

Examples of enhanced due diligence:

1. review of materials prepared by industry consultants and other institutions (including ESG specialists)
2. media and press reviews
3. interviews with management of relevant obligors
4. assessment of obligors' ESG policies and procedures
5. identification of remediation or rectification procedures
6. attending company, shareholder or senior management meetings

ESG divergence between the US, UK and EU



The UK has stated it will “*match the ambition*” of the Sustainable Finance Action Plan.

- The SFDR and Taxonomy Regulation were **not** onshored after Brexit.
- The NFRD is already part of UK law, but the UK will not implement the EU’s proposed changes; the UK Government has indicated that will align its regime in line with the recommendations of the Task Force on Climate-related Financial Disclosure (TCFD).
- FCA consultations: CP21/18 on climate related disclosures by standard listed companies and CP21/17 on a disclosure regime for asset managers and insurers
- HM Government: Greening Finance Roadmap – UK Sustainability Disclosure Requirements and the UK Green Taxonomy



USA: No legislation or rulemaking yet...but a major focus for the administration.

Divergence?

- EU regimes may well have extra-territorial effect in practical terms.
 - Detailed disclosure templates vs. principles based disclosure
 - Different taxonomies

Investor requirements and disclosure challenges (1)

Investor requirements

- ESG “negative screening”.
- Not always consistent or present across all CLOs.
- Specific and potentially shifting due diligence standard.
- Exclusions are often split between “norm or conduct-based” exclusions and “product-based” exclusions.

Examples of product-based exclusions:

1. weapons manufacturing
2. tobacco and similar
3. coal, oil & gas (specifics within those vary)
4. carbon intensity linked to electrical utilities
5. payday lending
6. opioid manufacturing
7. certain adult materials/activities
8. trading in endangered wildlife
9. illegal drugs
10. casinos and gambling

Investor requirements and disclosure challenges (2)

- Generally disclosure, whether trying to track regulation or investor requirements, remains a challenge.
- Lack of consistency and reliability of data.
- Currently no obligation on underlying borrowers despite SFDR, other potential regulation and knock on investor requirements requiring reporting.
- Existing regulatory framework disclosure templates are not well suited to CLOs.

Questions?

