KBRA KROLL BOND RATING AGENCY

ESG: Portfolio Screening in European BSL CLOs

Structured Finance: Structured Credit | ESG Research

Kroll Bond Rating Agency Europe (KBRA) has observed several instances of Environmental, Social, and Governance (ESG) considerations in a majority of our recently rated European broadly syndicated loan (BSL) collateralized loan obligations (CLO). The considerations impose additional eligibility criteria (screens) on the underlying portfolio, driven by investors and/or portfolio managers whose institutional ESG principles guide the investment in, or avoidance of, certain sectors or business activities. This report highlights some of the negative portfolio screens we have observed in our rated European BSL CLO universe, the environmental and social risks we believe the screens aim to address, and some of the diversification considerations that managers may face when applying ESG filters to portfolios.

Environmental and Social Screens Applied via Eligibility Criteria

Based on our review of the eligibility criteria in the transaction prospectuses, KBRA has observed various portfolio screens applied to European BSL CLOs. The exclusionary screens are generally based on the assumed negative environmental or social impact of an obligor's business activity (see Figure 1).

Figure 1: Environmental and Social Screens in KBRA-Rated European CLOs

	Obligor Business	Description	Environmental/Social Risk
Environmental	Thermal Coal	Extraction and use of thermal coal in electricity generation	Deforestation, carbon emissions/warming, human and animal displacement, species endangerment
	Palm Oil	Production of palm oil, ownership of plantations, lack of recognised sustainability certification or impact assessment, pending litigation with respect to land rights	Deforestation, carbon emissions/warming, human and animal displacement, species endangerment
	Tar Sands	Extraction or transportation of tar sands	Water conservation and contamination, deforestation, carbon emissions/warming, other pollutants
Social	Controversial Weapons	Produce, store, finance, transport antipersonnel landmines, cluster munition, chemical/bioweapons, nuclear weapons/programmes, or incorporated in a state not party to the Treaty on the Non-Proliferation of Nuclear Weapons of 1968	Existential threat, inhumane violence, and/or mass human casualty
	Pornography/ Prostitution	Trade in pornography or prostitution	Legality, addiction, health, and well-being
	Tobacco/ Alcohol	Production of tobacco/alcohol or tobacco/alcohol products	Substance abuse, health, and well-being
	Predatory Lending	Trade in predatory or payday lending activities	Economic injustice, disparity of wealth, household credit

Source: KBRA

Although transaction documents have been fairly standardised over the years, each transaction's eligibility criteria may have unique features, especially with respect to ESG screens. The collateral manager, based on the eligibility criteria, would generally be prohibited from purchasing loan or bond assets, where the obligor's business or revenue is linked to the products or activities described in Figure 1.

KBRA notes that the language used in ESG screens may not prohibit a manager from including exposures to screened activities. We have observed screens that look to an obligor's primary/principal business activity or the percentage of revenue it derives from a given activity, each of which would permit limited exposures to otherwise screened activities. In practice, however, we understand that managers may apply ESG screens in a relatively strict manner. Despite the qualifying language, the screens may often operate as de facto prohibitions. Given the additional limitations that screening poses on collateral eligibility, the consideration then becomes: is there any potential impact on portfolio diversification?

Diversification Comparison: Europe vs. US

A look at our rated universe of BSL CLO transactions shows more restrictive ESG-based eligibility criteria in European deals relative to US-based deals. A question KBRA often poses to collateral managers whose transaction documents contain ESG screens is whether there is any ongoing tension between the prohibitive nature of the criteria and the diversification profile of the managed portfolio. Anecdotally, European collateral managers have communicated this is not an overly onerous challenge as the criteria historically have only ruled out a small portion of the investable universe of loans. KBRA also notes that European CLO portfolios have typically been smaller and less diverse than their US counterparts by sector/issuer owing to the larger market for US CLOs and leveraged loans overall. Thus, while additional screens could potentially put pressure on portfolio diversification relative to transactions that do not have them, KBRA would not attribute lower overall diversification in European CLOs to ESG screening alone.

For additional context, we can look to a variety of metrics to compare portfolio diversity across transactions generally. KBRA incorporates diversity as a distinct input into our portfolio analysis, expressed on two levels (see **Structured Credit Global Rating Methodology**). We use a modified Herfindahl-Hirschman Index (HHI) to first come to an overall portfolio diversity measure (pDiv, based on obligor, industry, and credit quality) and then to a sector-level diversity measure (sDiv, based on number of issuers within a given sector). These metrics, along with the average number of unique issuers, average issuer notional concentration, and aggregate notional concentration of the 10 largest industry sectors (among others), can be useful for comparing overall diversification across portfolios (see Figure 2). We show the averages for each metric for our rated US and European transactions,[1] taken as of the date ratings were initially assigned.

[1] Includes 11 Published and two Unpublished US transactions and 9 Published European transactions.

Figure 2: Portfolio Diversity Comparison of KBRA-Rated US and European BSL CLOs		
Metric (Averages)	**US**	**Europe**
Notional Portfolio Amount	$500 Million	€360 Million
No. of Issuers	230	116
Issuer Size (%)	0.5%	0.9%
Largest Issuer (%)	1.1%	2.1%
Top 5 Issuers (%)	5.1%	9.3%
Portfolio HHI	685	810
Portfolio Diversity (pDiv)	83.7%	78.3%
Sector Diversity (sDiv)	57.8%	46.4%
Top 10 Sectors (%)	73.1%	78.4%
K-WARF*	2307	2434

Note: US metrics include Published and Unpublished ratings. European metrics include portfolio information for two transactions that have not yet closed. Numbers are rounded to the nearest whole numbers or one-tenth of percentage, respectively, for illustrative purposes.
* The KBRA Weighted Average Rating Factor (K-WARF) for a portfolio is the weighted average of the KBRA rating factor (K-RF) of each obligation in that portfolio. The K-RF is each obligation's five-year probability of default, which is based on the individual credit assessment of the obligor, multiplied by 10,000.
Source: KBRA

All else equal, a lower HHI and higher pDiv and sDiv equate to a more diversified portfolio and vice versa. Figure 2 shows that, compared to the US, KBRA-rated European CLOs have held approximately half the number of unique issuers within their portfolios, approximately double the average issuer holding, and have lower overall pDiv and sDiv percentages. Reducing the number of issuers or industries in a portfolio may increase concentration and overall credit risk. As seen above, European deals rated by KBRA have a slightly higher K-WARF than US deals. However, CLOs can be structured with more credit enhancement to offset less overall diversification.

ESG Utilisation Going Forward

Negative screening for ESG considerations does not appear to be a limiting factor for European managers when it comes to portfolio construction or rebalancing. Further, KBRA believes this is unlikely to change moving forward. Indeed, it is possible that the European CLO market will begin to move away from the current "ESG-negative" approach in favor of an "ESG-positive" approach, with ESG scores for each asset and a target portfolio weighted-average ESG score (we note at least one deal in the broader market with this feature). All else equal, an ESG-positive approach could enhance portfolio diversification and differentiation over time, mainly because it would be less binary in terms of asset eligibility. It could also broaden the investor base, potentially boosting liquidity in the CLO and leveraged loan markets. KBRA will continue to track ESG developments, including signs of a wider move to an ESG-positive model, as they relate to CLOs and other structured credit transactions.

KBRA's analytical approach aims to capture all meaningful factors, including ESG, into our ratings when we believe there will be an impact on the credit in the near term or in the future, after considering risk mitigation efforts. Factors that may influence CLO analysis such as portfolio diversity are not always static and require continuous surveillance. As credit factors develop, they are incorporated into KBRA's surveillance reviews. And as new information becomes available and as future expectations evolve, the information and expectations may trend in a way that could materially impact KBRA's credit analyses and ratings.

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