

## A FIVE-PART FRAMEWORK FOR ESG DISCLOSURES IN GLOBAL LEVERAGED FINANCE

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The effect that ESG factors have on credit fundamentals underscores that comprehensive ESG disclosures are no longer a “nice to have.” Rather, they are an investment imperative, as we explain below. While the global investment-grade universe has made notable progress on disclosures, companies in the global leveraged finance universe remain conspicuously behind. Given this delay and the need for standardization, we introduce a five-part framework of tangible steps that leveraged finance companies might reference when attempting to meet investors’ heightened disclosure demands.

More fixed income investors are seeking - if not demanding - comprehensive ESG disclosures from issuers, and we are among them. However, our long-standing integration of ESG factors into credit analysis and the assignment of ESG Impact Ratings across all of our issuers continue highlighting the disclosure deficiency within the global leveraged finance sector.

We integrate ESG factors for good reason: ESG failures present material credit risks. For example, within the emerging market high yield corporate universe, default rates in the oil & gas and metals & mining industries are more than double those in other EM corporate industries. Sensitivity to commodity price volatility and instances of ESG shortcomings have contributed to the elevated default rates in these closely watched industries as we show in an upcoming white paper.

In terms of the scale by which the global leveraged finance sector lags its peers, we compared ESG coverage on our representative portfolios for our global investment grade, high yield, and leveraged loan strategies (Figure 1). While nearly 3/4 of global investment-grade names presented greenhouse gas coverage using reported data, less than 1/3 of global high yield names presented similar coverage. A nearly non-existent representation among global leveraged loans - less than 1/20<sup>th</sup> - presented greenhouse gas coverage using reported data.

**FIGURE 1: THE SCOPE OF THE LEVERAGED FINANCE DISCLOSURE CHALLENGE**

Third Party Coverage of Greenhouse Gases (GHG) Intensity for Global Investment Grade, High Yield, and Leveraged Loans.

Portfolios % MV with:	Third Party ESG Ratings Coverage	GHG Intensity Data Coverage (Reported and Estimated)	GHG Intensity Coverage Using Reported Data
PGIM Fixed Income Representative Global Investment Grade Bond Portfolio	94%	94%	74%
PGIM Fixed Income Representative Global High Yield Bond Portfolio	71%	70%	30%
PGIM Fixed Income Representative Global Loan Portfolio*	8%	8%	4%

Source: PGIM Fixed Income. As of February 2021. The above information is shown for illustrative purposes only and is not inclusive of all ESG potential issues and engagement. ESG ratings are subject to change without notice. Please see the notes for additional disclosures. \*Coverage is for 82% of the portfolio comprised of loans.

Considering the sizable gaps in coverage, our five-part framework proposes a basic level of ESG disclosures for global leveraged finance issuers, which consists of the following:

1. Identify and disclose material ESG risks and opportunities for the business.
2. Identify and disclose positive and negative impacts that the company's business activities have on the environment & society.
3. Disclose material ESG risks and impacts in the annual report and accounts. Describe mitigation and management measures taken to address ESG risks and key negative impacts. Where ESG factors and trends lead to new business opportunities or where there is a scope for positive contributions to the environment and society, highlight those with commentary on actions taken or planned.
4. Provide as much data as possible for ESG risks and impacts. Quantitative data also supports peer comparison, modelling, and portfolio analytics.
5. Focus on ESG factors that are relevant and important for the industry, company, and supply chain. For example, on the environmental side, these could be GHG emissions, environmental pollution, water withdrawal, waste generation, biodiversity loss, etc. On the social side, these could be workforce-related issues (e.g. occupational health and safety, diversity and inclusion), or product/customer-related issues (e.g. product safety, data privacy and security), or value chain-related issues (e.g. human rights violations). On the governance side, key issues include ownership structures and controls, corporate governance, investor rights and credit protections as well as business conduct issues.

Standardised frameworks can help guide such disclosures, and we support standards developed by the Sustainability Accounting Standards Board as well as the recently launched guidance on ESG disclosure by The European Leveraged Finance Association (ELFA) and the ESG Questionnaire launched by The Loans Syndication and Trading Association (LSTA).

These initiatives reinforce investors' requirements for comprehensive disclosures. Our desire is that disclosure standards, along the lines of the five-part framework provided above, incentivize leveraged finance issuers to join their investment-grade counterparts with comprehensive ESG disclosures as it may become an increasingly important determinant of their future cost of capital.

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