Environmental Finance

The 'phenomenal challenge' of TCFD reporting for alternative credit managers

03 January 2025

By Ahren Lester

Climate reporting is challenging for alternative credit, but Alcentra's Vai Patel tells Ahren Lester it is an opportunity to be ambitious.

Alternative credit managers can be "ambitious" with their sustainability impact through Task Force on Climate-Related Financial Disclosures (TCFD) reporting and engagement with market participants, despite the current climate data limitations facing the sector, Alcentra said.

The investor's ESG head Vai Patel told *Environmental Finance* the $32 billion asset manager has tried to be "very ambitious" with its TCFD reporting process, which has resulted in a "best-in-class approach".

"The simple reason is that some of the key challenges for alternative credit managers is access to data and management teams," he said. "But we actually wanted to figure out how best to work within those limitations, but also to actually encourage our investees to not only produce the climate data but also commit to a net zero target themselves."

Alcentra, which is the credit specialist arm of Franklin Templeton, has sought to model the performance of all its assets – about 400 in total – under different climate scenarios out to 2050. Despite the "comprehensive and laborious process" to produce this, Patel accepts that this forward-looking data is imperfect. Yet this does not diminish the importance of the work.

"The idea is not to be fixated by the exact number, but to understand the portfolio and sector exposures from across our strategies and how your portfolio is likely to evolve," he said. "And, being mindful of that can then inform our decision in terms of how we engage with those borrowers and how we encourage them to set meaningful targets in return."

Alcentra has also set a more "tangible and meaningful" target to cut portfolio emissions by 50% by 2030, which most of its peers have not yet committed to.

A balanced approach

Patel accepts that alternative credit managers face an array of different challenges in engaging with investees.

For direct lending strategies, for example, Patel said its role as sole lender in most of these deals to smaller or more illiquid private companies means borrowers tend to "play ball" and provide all the data they can when asked, even when internal resources to produce this is limited.

For other strategies where Alcentra may be a minority investor in debt – such as its European Liquid Credit strategy – it is a "little bit more difficult" to leverage its investment to improve sustainability disclosures and commitments, however. Nonetheless, these companies tend to be larger and so already have more structure around sustainability disclosures and strategy – helped by the "tailwind" from regulations, especially in European markets.

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As a result, Patel said there was a "balance" of approaches that alternative credit managers like Alcentra can utilise in their engagement.

Catalysing CLOs

However, the most “nuanced” – but potentially even more impactful – approach has been taken to its structured credit portfolio which sees Alcentra investing in other Collateralised Loan Obligation (CLO) managers – such as Permira, Blue Bay, or Blackstone.

“We pretty much cover the entire CLO market through that desk,” he said. “So, we actually reached out to about 90 CLO managers as part of our annual questionnaire. Through this, we made a very big push on TCFD and asking them to do the climate modelling [for their investments] that we have done ourselves.”

At this stage, Patel said “most” CLO managers could not fill in this questionnaire. But he said Alcentra also published a number of climate guides – including guidance around the status of climate science and points around how to calculate data – to help CLO managers think about the issue. He claimed this has “already started to move the dialogue a little bit on that front”.

Indeed, Patel said the conversation with one major UK-based CLO manager around the questionnaire highlighted that they were not even aware they have to produce a TCFD report themselves. More generally, however, he said several conversations with managers demonstrated that they found the guides “helpful” in understanding their own reporting approach.

“Some have definitely utilised our methodologies and our way of thinking, which has been great,” he said. “But, especially in the US, others just see this as a tick-box exercise, which is understandable – and that will take a little bit of time to change. But, even if we get half the CLO managers [to improve reporting], that is still better than none.”

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Patel said Alcentra’s annual ESG questionnaire to CLO managers asks them to demonstrate how they have improved their reporting processes year-on-year. The company will use this data to engage with those managers that don’t demonstrate improvements.

Patel said this was another area where Alcentra is trying to be ambitious in its approach to sustainability reporting, by encouraging wider improvements.

“Not only are we directly [improving reporting] with the investments that we have, but actually we are doing it indirectly through the CLOs – who themselves have underlying exposure to about 10,000 companies. So, what we are doing is quite material and ambitious.”

Market movement

This work has been undertaken to make a process that is “phenomenally challenging” more “feasible” for alternative credit managers such as Alcentra, Patel said.

“The only practical way we can all get there is if everybody is asking the same thing [from borrowers],” he said. “It does not work if only 20% of the market is asking the same thing. It only works if 80%, 90% or 100% of the market is basically setting out the same requirement of borrowers.”

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The TCFD’s recommendations have been subsumed into the International Sustainability Standards Board (ISSB) standards, which are being adopted by numerous jurisdictions across the globe, while the EU’s Corporate Sustainability Reporting Directive standards also incorporate the TCFD recommendations.

And although regulation is “very helpful,” managers are having to “navigate” the lack of consistency between the regulations. For example, he said the reporting requirements under the EU CSRD are “not exactly consistent” with the regulations around TCFD reporting.

“But the point is, if we don't do this now, we absolutely will not get to anywhere near 50% [emissions reductions] by 2030, let alone net zero by 2050. So, we have to be pushing this now [or else] the transition pathways are just not realistic. And, if we miss the 2030 target, we are not going to get there by 2050. It is really quite simple as that."