SPECTRUM

ABS analysis: through the ESG lens

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The drive to push environmental, social and governance (ESG) investing into the mainstream has dominated the asset management industry in recent years. While the discussion on ESG in many asset classes is well progressed, to date there has been less focus on ESG in asset-backed securities (ABS). Beyond looking at the explicit environmental elements of green ABS, there has been little emphasis on assessing the social and governance factors within securitisation. In this issue of *Spectrum*, we consider all three axes of E, S and G in the ABS space.

KEY POINTS

- **We can extract ESG factors when analysing the underlying assets backing securitisations; how these assets are serviced; and, how transactions have been structured.**
- **Building a framework for assessing ESG within ABS transactions is the next step for investors to incorporate these factors into their credit analysis.**
- **More data which isolate the impact of ESG factors on financial performance are required to fully appreciate the integration of ESG analysis in credit.**

THE E OF ESG

Green residential mortgage-backed securities (RMBS)[1] is an established asset type, although it is still in its nascence in Europe, where the Netherlands is leading the way in terms of issuance. For example, Dutch mortgage provider, Obvion, has issued over €2bn of bonds backed by green mortgages under its Green Storm programme since 2016.

However, despite being a growing market, the immediate scalability of green mortgages as an asset class may be challenged, particularly in Europe where a significant proportion of housing is old and difficult to make improvements to. This is likely to act as a cap on green RMBS issuance over the coming years, regardless of the increased focus on promoting energy-efficient housing as well as the financing of these properties.

Another issue weighing on the growth of green RMBS is the lack of standardised classification as to what constitutes green housing. In the European Union (EU), the Energy Efficient Mortgages Action Plan (EeMAP)[2] is seeking to tackle this issue by creating a standardised energy-efficient mortgage to incentivise property owners to improve the energy efficiency of their buildings. For such an initiative to succeed, not only does the market require a standardised approach to categorise energy-efficient properties, it will also need the financing of these properties (through mortgages) to be underwritten in such a way that borrowers can obtain preferential rates.

A green advantage?

Based on the data we have so far, it is difficult to conclude whether ABS and RMBS with strong environmental credentials perform better than those with less of a green focus.

At present, there is little evidence to suggest that borrowers with energy-efficient properties are less likely to go delinquent and default on their mortgages. Of course, lower energy bills will improve a borrower's affordability metrics and the values of energy-efficient properties could outperform those of less efficient properties, especially if the regulatory and political tides move to discourage energy-inefficient housing.

An analysis by Bank Underground[3] – a blog run by Bank of England staff – provides early evidence that residential mortgages on energy-efficient properties display lower arrears than energy-inefficient properties. However, it is impossible to determine at this stage whether those borrowers are just more conscientious and would have serviced their debts in a similar fashion on less energy-efficient properties, or whether the performance can be attributed to the energy efficiency of the properties. So until enough data becomes available to show that these borrowers have a lower risk profile over housing market cycles (which requires many more years of information and evidence), lenders are likely to be slow to incentivise green property improvements through lower rates (notwithstanding regulatory pressures); rating agencies will be unable to re-calibrate their models for energy-efficient lending until sufficient data are available; and, investors are unlikely to accept lower yields as a result (notwithstanding the requirement of some vehicles to meet ESG investment guidelines).

Similar arguments could be applied to green auto ABS. We are not yet in a position to ascertain whether borrowers financing green autos (electric vehicles and hybrids) are less likely to go delinquent on their loans than those taking out loans or leases on petrol or diesel cars.

This is well illustrated by the Volkswagen (VW) emissions scandal. The discovery by the US Environmental Protection Agency had a significant impact on VW's corporate debt and equity prices, but the impact on its auto ABS was much more muted. This reflected the expectation – which was borne out in subsequent performance – that despite the company's ESG shortcomings, borrowers within VW auto

[1] Green residential mortgage-backed securities (RMBS) are mortgages on energy-efficient properties.
[2] Source: EeMAP
[3] "Insulated from risk? The relationship between the energy efficiency of properties and mortgage defaults," published by Bank Underground in October 2018.

ABS pools were unlikely to stop paying their loans or leases. That said, the reduction in second-hand car values and the impact on the overall brand had to be factored into structures that were exposed to residual values.

Whereas energy-efficient properties may benefit from enhanced values over time compared to energy-inefficient properties, the improved valuations argument may not necessarily hold up for greener autos. That's because the second-hand premia for such vehicles could be offset by *technological obsolescence*. To date, the green auto ABS market has not emerged as an asset class and Moody's expects the penetration of electric vehicles within the global fleet to reach just 2% by the mid-2020s and 5% by the end of that decade, with regional variations. So, while the market is growing, it is expected to remain relatively small for the foreseeable future, although political involvement could encourage faster adoption of cleaner auto formats in this timeframe.

The application of the 'E' factor to ABS benefits from a very clear use-of-proceeds argument which can sometimes be more complex in corporate borrowing – i.e. the collateral backing the securitisation vehicle is eligible for inclusion due to set environmental characteristics defined upfront, whereas corporate borrowing via a "green bond" issuance may not necessarily use the proceeds for green projects. Instead, the money could be used for more general corporate financing.

At Hermes ... ESG is not simply an ethical imperative when it comes to investing in credit, it also results in better financial performance

Credit analysis: through the ESG lens

To extract ESG factors does not require a total rethink of how to perform credit analysis in ABS. We simply need to look at the analysis through an ESG lens.

At Hermes, we approach ESG not as an add-on to how we view credits but as core to how we analyse the asset class and how it performs – in other words, ESG is not simply an ethical imperative when it comes to investing in credit, it also results in better financial performance[4].

Within the ABS asset class, investors have most likely been considering a lot of the following aspects, but we haven't necessarily viewed them through the ESG lens. Here we discuss familiar credit considerations as ESG factors – and by looking at the asset class in this way, we believe that we will be able to successfully incorporate ESG without having to rewrite the way we analyse credit.

Extracting social and governance factors within ABS

For market participants, it has not always been obvious how social and governance factors can be applied to ABS transactions and structures.

For example, when analysing governance factors in ABS, it is clear that the special purpose vehicles (SPVs) that hold the assets and issue the bonds of a securitisation are not analogous to corporate entities. That's because they do not have boards of directors with corporate strategies (that may or may not include ESG criteria) or traditional governance considerations such as board diversity.

By using elements of the credit analysis process for ABS transactions (see Figure 1), we discuss some of the ways in which traditional ABS credit analysis can extract the social and governance factors. We also explore ways to find the interconnections between the environmental, social and governance factors as they do not necessarily have to be viewed in isolation but can be seen to support one another.

Figure 1. The credit analysis process for ABS transactions

Source: Hermes as at September 2019.

[4] See our commentary: "Pricing ESG risk in credit markets: reinforcing our conviction," for more information.

SOCIAL FACTORS: LENDING TO THE REAL ECONOMY

When looking at the social aspect of securitisation, a good starting point is the concept that the vast majority of securitisation is backed by assets that are financing what is termed the "real economy" – products to help ordinary consumers finance their everyday lives.

In Europe, the largest sectors of the ABS market are residential mortgage-backed securities and auto ABS – securitisations of auto loans or leases to consumers. Indeed, there is an undeniable social aspect to providing financing that enables ordinary consumers to buy a home and drive a car.

Additionally, securitisation can have benefits for the originating financial institution – and these can be passed onto consumers in the form of lower costs of borrowing.

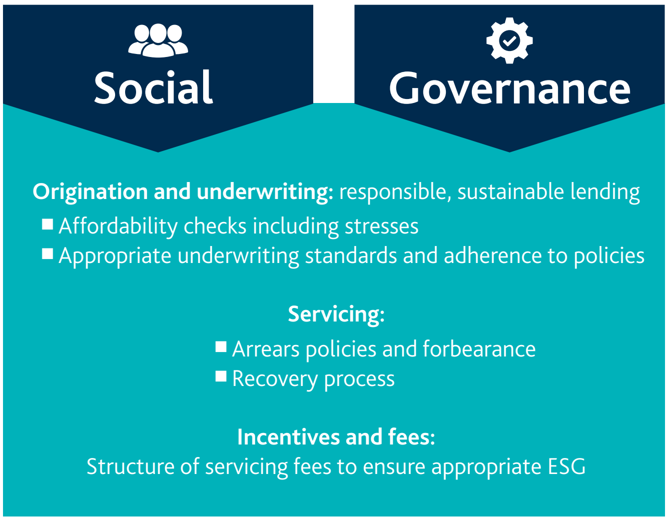
Securitising pools of such assets not only provides the financial institutions originating the mortgages and loans with an additional source of funding, but it also takes the pools of collateral off balance sheet, with subsequent credit risk transfer benefits.

This results in financial institutions having increased capacity to extend such lending to consumers and it can have a positive impact on their overall cost of funding. This can be passed onto consumers, resulting in better pricing for their mortgages and loans.

Although these are important social factors backing the argument for securitisation, they are general factors – they do not differentiate between originators or the individual credit merits of individual transactions. To do this, we have to dig further.

Origination and underwriting: considering the quality of lending

Figure 2. Some social and governance factors are interconnected



Source: Hermes as at September 2019.

Good governance in origination and underwriting practices can support the social factors as well

To differentiate between originators, it's not enough to recognise that lending to consumers has a social aspect to it: the quality of that lending also has to be considered. As evidenced by the collapse of the sub-prime market in the US, poor underwriting and the provision of unsuitable products to borrowers do not end well – not least for the borrowers themselves, who ended up with poor credit records that impacted their borrowing capacity for years to come.

This is where the social and governance factors start to interact and interconnect – good governance in origination and underwriting practices can support the social factors as well. It is therefore vital to consider the sustainability of the lending – assessing whether borrowers can afford to pay, not only in the current environment, but in other economic conditions, including stressed scenarios – when we're analysing the risks inherent in lending to consumers.

Mortgages

These types of sustainability considerations are particularly important for mortgages, which tend to be long-term in nature and can exist through a number of economic cycles. There were a number of issues surrounding the pre-crisis sub-prime mortgage market. But at its core, there was a key problem: mortgages were designed to be reset and refinanced in just a few years, based on the assumptions that there would still be mortgage products available to those borrowers, thereby avoiding the higher rates at reset, and that valuations would be supported in a rising housing market. Not enough consideration was given to the implications of what would happen to those borrowers who couldn't refinance when their rates had reset in a housing market that had cooled and where valuations were under pressure. In other words, the products became unsustainable as the resets meant borrowers could no longer afford their mortgages and the valuations of the properties had also declined, leaving the outstanding mortgage balance greater than the realisable value of the property.

Mortgage regulation

A number of regulations have been introduced to prevent the re-emergence of loose mortgage lending standards in the market.

For example, the UK's Mortgage Market Review of 2014 requires a more stringent assessment of a borrower's ability to pay their mortgage. This is conducted through extensive affordability checks that not only analyse a borrower's incomings and outgoings, but also their ability to pay their mortgage under more onerous rate environments. While some borrowers will no longer pass the checks, it does mean that those who do are more likely to be able to afford their mortgage on a sustainable basis. This is good from both a social point of view (borrowers are able to stay in their homes) and a governance perspective (it supports sustainable long-term lending rather than short-termism). In turn, it supports the financial prognosis of deals that contain such mortgages.

It's not enough, though, for investors to rely on regulation to capture all of the social and governance aspects of underwriting and origination. Investors must also consider an individual lender's practices and track record:

- **Does the lender have appropriate underwriting procedures and policies?**
- **Does the lender adhere to these procedures and policies?**
- **Does the lender have scorecards for borrowers?**
- **How often are these scorecards reviewed/back tested/revised?**
- **Are manual over-rides possible?**
- **What level of experience does an underwriter need to attain before being able to over-ride the automatic decision?**
- **What is the performance of these manual overrides compared to the general cohort of loans?**

Over time, performance data will show whether the lender provides financing on a sustainable basis. If delinquencies are mounting up quickly and defaults are running at high levels, it would suggest a lender has been underwriting unsuitable products, financing borrowers with unsuitable creditworthiness, or both.

In addition, it could be argued that high loan-to-value (LTV) originations should have low social and governance scores because they are inherently riskier. With less equity in the property, if house prices were to decline, the borrower could find that the value of their property is less than the outstanding balance of their mortgage. Such a scenario is typically more prevalent during downturns in the overall economy, with higher unemployment also a feature. And should the borrower default in this situation, the lender would find that selling the property alone would not cover the mortgage they have underwritten. In jurisdictions where mortgages are extended on a full-recourse basis, the lender would be able to recoup the losses incurred from the property sale from the borrower's other assets.

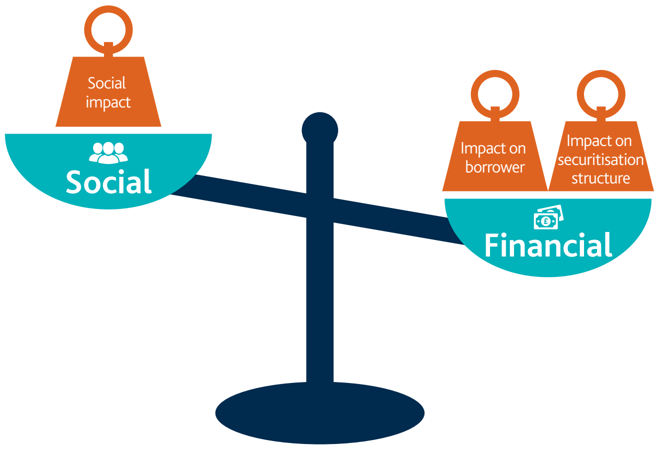
Yet such products in themselves need not necessarily score worse on both social and governance factors. From a social perspective, higher LTV products enable borrowers who might otherwise be unable to buy a property to do so (property ownership is seen as desirable in most developed economies).

Servicing: a balance of social and governance factors

A lender may have been meeting social and governance criteria in the way it underwrites and originates its products, but it can hardly be expected that every borrower will service their debts as required.

Investors in securitisations should always expect a certain level of delinquencies and defaults, no matter how stringent the underwriting or how high the quality of originations.

Figure 3. A balancing act: social and financial impacts



Source: Hermes as at September 2019.

There is an obvious financial impact when borrowers go delinquent or default on their mortgages or loans, but social and governance factors come into play in the way that the lender deals with those borrowers. As an investor, it is our responsibility to analyse the arrears, the collection, the debt management and the forbearance policies of those lenders as well as the recovery processes they use. There is a social imperative to allow a borrower to remain in their home or to continue to use their car (which they may need to get to work), even when they have ceased to service their debts on those assets. However, this also has to be balanced against what is financially prudent – what makes sense for the lender's position in recouping the money they have lent. Part of this is considering whether it is socially responsible for a borrower to be overburdened in how they have to finance their debts when they have little chance of getting back on track – the interest payments and default fees would mount up and make the loan or mortgage even harder to pay off.

Of course, lenders will have arrears policies in place, and they will follow debt-management procedures to collect from borrowers who have gone delinquent or defaulted on their loans or mortgages. Lenders generally want the borrower to get back on track rather than having to immediately go down the foreclosure route. They have a number of strategies at their disposal – for example, they can extend the term of the loan, thereby reducing the regular payments; they can give the borrower a payment holiday until any temporary cash flow situation is resolved; or they can transfer them to a different product (for example, moving a borrower from a repayment mortgage to an interest-only product will reduce their monthly payments).

The course of action needs to be analysed by the lender and should be implemented on an individual basis, taking account of the specific circumstances. For instance, someone who has lost their job and is likely to struggle to find alternative employment quickly has a very different outlook to someone who is going through a divorce and is in the process of selling their marital home. The former is potentially a longer-term problem, while the latter is more likely to be temporary and will be resolved once the house is sold.

Scoring lenders on social and governance practices

Although there is a certain amount of legislation around how products are serviced to retail customers, there is still considerable variation in how lenders deal with delinquent and defaulted borrowers. It is here that investors can score lenders on both their social and governance practices.

Investors may look to score lenders worse from a social perspective if they lean towards quicker enforcement rather than forbearance and do not fully explore the full range of options to help borrowers get back on track. Also, investors may view lenders more negatively if they have implemented policies that could result in treating borrowers harshly when certain unavoidable life events occur.

There is a highly charged social argument involved in foreclosing on a borrower who has defaulted on their mortgage as it involves people losing their home. However, this immediate aspect has to be weighed against the longer-term social considerations. Over the long term, it can be argued that the borrower is better protected from further interest and fees accruing by taking expedited action rather than letting the situation escalate if the borrower remains in the property.

> **Investors need to weigh such social and governance factors against the financial considerations. ESG factors should support the financial performance of the bonds**

Ultimately, investors need to weigh such social and governance factors against the financial considerations. ESG factors should support the financial performance of the bonds – a borrower who starts to re-perform is good for the financial situation of the securitisation. Equally, the documentation governing an ABS structure may not allow for restructured loans to remain in the collateral pool, thereby protecting ABS investors from the financial implications amending the terms of the underlying loans.

Finding the right balance between foreclosure and forbearance also has financial implications. In jurisdictions where foreclosure has been made more difficult by regulators, there has been evidence of borrowers who have the ability to pay but decide not to as lenders are limited in their ability to foreclose. The feedback loop is inevitably that there is an increased financial burden on the lending institution which ultimately filters through to the rates they charge borrowers for similar loans.

Servicer remuneration: appropriately incentivised?

From a governance perspective, investors in securitisation structures need to assess whether servicers are being appropriately paid to perform their work. Are incentives and fees aligned with an investor's interests – that is, will the servicer's actions result in better financial performance, and if so, can these actions be viewed positively from a social point of view? This is very similar to how investors apply governance considerations when analysing whether corporate boards and management teams are appropriately incentivised to run a company effectively.

GOVERNANCE IN SECURITISATION STRUCTURES

It is also important to consider governance factors when it comes to securitisation structures: the structure features of transactions as well as the type of risk mitigants and noteholder protections in a deal are crucial aspects for investors.

The devil is in the detail, and sometimes the pivotal features that make a structure strong or weak can be difficult to find in documentation – which can be hundreds of pages in length. It is, therefore, essential that investors have enough time and analytical capacity to thoroughly review the offering circulars and other transaction documents that govern how a deal operates.

Ultimately, we are considering whether the structure adequately protects the financial interests of investors:

- **Can investors reasonably expect to receive interest and principal if the underlying assets are performing within expectations?**
- **Do the interest and principal waterfalls makes sense?**
- **Ultimate versus timely payment of interest? Conditions for the deferral of interest?**
- **How does the structure deal with underperforming collateral?**
- **Are there reserve funds? What can they be used for?**
- **Are there triggers in the structure that would result in increased noteholder protections/earlier repayment if the underlying assets perform worse than expectations?**

Such considerations are likely to be already embedded in the credit analysis undertaken by investors, although they may not necessarily be explicitly seeing them through an ESG lens, particularly when it comes to the governance of structures.

Risk retention: alignment of interests

In response to the financial crisis where the loosening of underwriting standards was supported by an originator's ability to exit the risk of those assets by selling them into securitisations, regulators in the US and Europe deemed it necessary for originators to retain some "skin in the game" – in other words, originators had to retain a certain economic interest in the pools of assets that go into securitisation SPVs.

Risk retention – typically a minimum of a 5% economic interest in the securitisation – was introduced in the US and Europe to ensure originators' interests were aligned with the long-term performance of the assets they had underwritten. Originators were no longer able to effectively walk away from bad mortgage or loan originations – if the pools of assets backing securitisations start to perform badly, the originator will suffer losses alongside investors.

The introduction of risk retention prompted originators to look more closely at how to ensure the sustainability of their loan products. However, there are ways in which risk retention can be structured that move away from the spirit of what the regulation intended so investors need to look carefully at the details of exactly how the risk retention has been structured.

Transparency of reporting

One of the more common issues going into the financial crisis was the lack of transparent and standardised reporting for securitisation transactions. Following the financial crisis, there has been a big push, especially in Europe where homogeneity of reporting was particularly absent in the lead up to the financial crisis, to improve this situation, and in recent years, European regulators and institutions have drawn up extensive rules around what is called STS – simple, transparent, standardised – securitisation.

Moreover, reporting and transparency standards have been enshrined in European securitisation with the implementation of Securitisation Regulation at the beginning of 2019. Without delving into a deep discussion of the regulation itself (we can save that for another time), the fundamental motivation for the regulation was a move in the right direction for the purposes of creating a higher standard for reporting and transparency, thereby increasing the trust people have in the asset class.

The move to STS structures is closely aligned with the governance of securitisation, and it is clear that a structure's governance can vary greatly from deal to deal.

ESG in ABS: moving forward

While the application of ESG analysis to ABS has not developed as much as it has for other asset classes and we currently do not have any third-party agency providing ESG scores for ABS transactions, there are plenty of potential ways for ESG analysis to be used when looking at securitisation which investors can consider.

Many of the elements that are already part of the credit analysis of ABS deals can incorporate ESG factors, even though issuers and investors have not yet necessarily highlighted them as specifically ESG-related. Not only can we draw out ESG factors when analysing the underlying assets backing securitisations, we can also consider ESG factors when analysing how those assets are serviced as well as the structures themselves.

Not only can we draw out ESG factors when analysing the-underlying assets backing securitisations, we can also consider ESG factors when analysing how those assets are serviced as well as the structures themselves.

Building a framework for assessing ESG within ABS transactions is the next step for investors to incorporate these factors into their credit analysis. In this issue of *Spectrum*, we have alluded to some of the building blocks required to establish a framework for scoring the ESG factors of ABS transactions and differentiate between deals. But to further the development and discussion, more data collection as well as quantifiable proof that deals with better ESG scores lead to better financial performance are required. In turn, this will not only encourage the expansion of ESG products but ESG investing in the asset class too.

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OUTCOMES BEYOND PERFORMANCE

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Edge
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