ESG Criteria in Securitization

State of the market

The incorporation of ESG criteria in securitized products lags other fixed income asset classes. This is largely due to the complex nature of the products, which in turn creates a ripple effect on the ESG analysis requirements.

While there are already some examples of ESG products in the securitized world, mostly as Mortgage Backed Securities (MBS) and Collateralized Loan Obligations (CLO's), the biggest concerns revolve around the following issues:

1) How to build a framework that will encompass the ESG factors through all the stages of a securitized security creation, from the multiple parties involved in origination to enhancing credit risk assessment.

2) Uncertainty as to what constitutes green securitization due to the lack of labeling standards, whether it's at the pool, originator or trustee level.

How do ESG CLOs work ?

In the absence of a standardized definition of an ESG CLO, the best way to go about building one is to align the interest with the largest buyers' and their disclosed frameworks. One of the most common and basic forms of ESG screening is industry-based screening. Collateral obligations that operate in certain specified industries are ineligible for inclusion in a deal. Frequently excluded sectors are coal-based energy production, weapons, hazardous chemicals and tobacco.

Beyond the industry screening step is the concept of ESG scoring through which each obligor is attributed a score. This would potentially allow for companies with high ESG compliance, but operating in an industry in transition towards net zero to make its way into a securitized product. On the contrary, the ESG score would also prevent CLO-eligibility for an unethical company operating in the most environmentally friendly industry. The loan portfolio to be pooled can then be evaluated with a materiality threshold, or a minimum tolerable score.

Sources: https://www.unpri.org/fixed-income/esg-incorporation-in-securitised-products-the-challenges-ahead/7462.article#Appendix_3_CRAs_and_ESG_factors
https://www.jdsupra.com/legalnews/talking-about-a-revolution-making-esg-7934236/
Bloomberg

Types of ESG securitizations

While the pooling of ESG-stamped collateral provides the most transparent channel for a securitization product, the strict view regarding the nature of the underlying assets coupled with a lack of availability of these assets is limiting the rise of originations. In a world where most developed economies lean towards a future without carbon emissions, there could be a way for securitization to support the transition through some innovative ideas such as use of proceeds securitizations.

ESG collateral securitization

The most convenient kind for ESG acceptation, known as ESG Collateral Securitization, is one in which a portfolio of homogenous assets which are already characterized as being ESG is pooled to create a new security. For instance, green residential mortgages and auto loans for electric vehicles have been used for these purposes. However, the lack of available assets puts a limitation on this type of pools.

For investors, this type of asset pooling makes the ESG selection quite easy. There is a much lesser risk of ESG-washing through the intuitive link to ESG, and the underlying cash flows all come from ESG dollars.

Use of Proceeds

The use of proceeds securitization is not currently marketed as an ESG product. Nonetheless, the scope for such innovative product could contribute greatly in the support towards transition of economies globally. As the name implies, a use of proceeds securitization is characterized by underlying assets that may not fit the strict ESG criteria, but the financing raised by the transaction is used for ESG objectives.

ESG use of proceeds securitizations have very distinct characteristics in regards to the pool of assets, but possess a clear ESG message in the restrictive use of proceeds. From its less restrictive nature compared to ESG Collateral Securitizations by being unrestricted to a pool of diverse assets, use of proceeds type of transaction attract larger financing volume and enable the origination of further ESG assets going forward. In such manner, a use of proceeds securitization is naturally channeling funds towards a subsequent purely ESG securitization (ESG collateral method). In other words, a use of proceeds issuance would raise funds for future pure ESG loans, which could then be pooled and sold.

For the use of proceeds product format to thrive, there remains a gap to bridge as investors may require a greater level of transparency and improved impact reporting. The players in the securitization market are already used to a highly scrutinized data reporting workload and high levels of asset transparency. The immediate challenge resides in finding a way to demonstrate its necessity and alignment with the ESG guidelines authorities.

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Sources: Bloomberg
https://www.matheson.com/insights/detail/esg-clos-the-opportunities-and-challenges

ESG Assessment of an asset-backed securitized product

A layered approach to ESG

Due to the nature of a securitized product, many parties will be involved in the origination and operation of a pool. ESG considerations are expected to span across all 3 layers exhibited below.

ESG exposure to the originator, servicer, guarantor

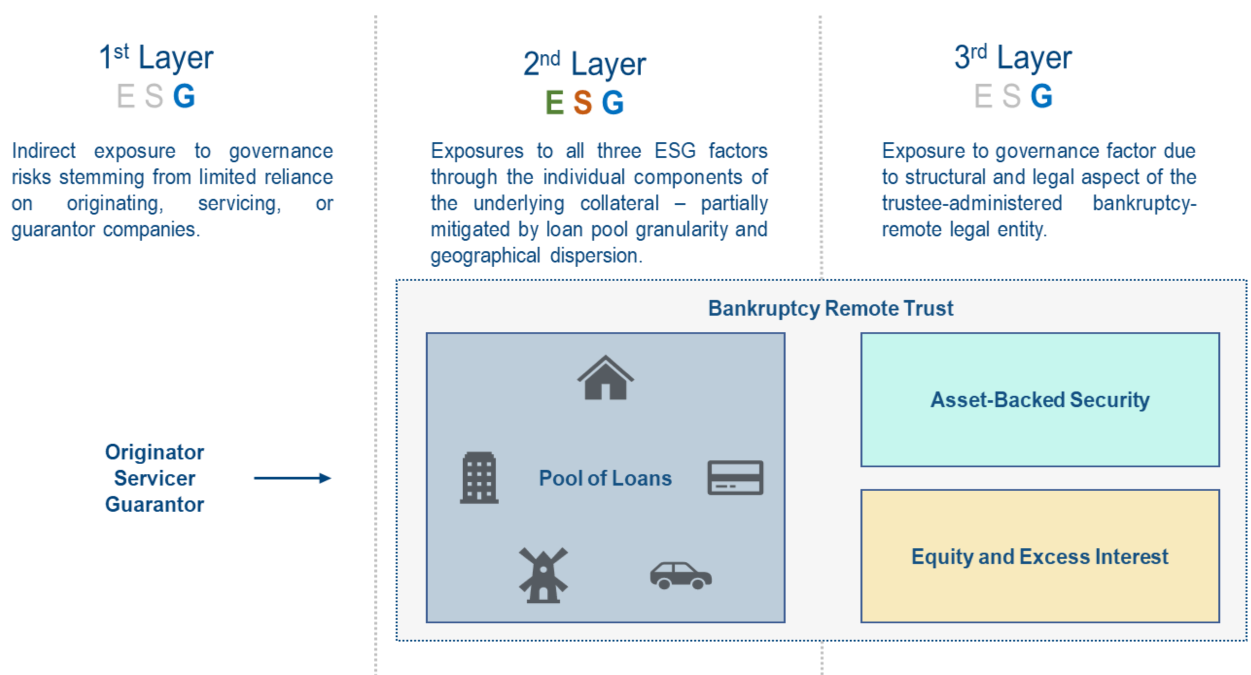
As shown in exhibit 1 below, the ESG risk stemming from the originator, servicer or guarantor of a securitized product is much smaller than it would be in a corporate bond since the pool of assets is held in a separate legal entity. Nonetheless, there are risks remaining regarding the collection of payments and origination of new loans to add to a securitization trust.

ESG exposure to the collateral pool

As this is the core of the product, this is where the highest risk resides. Exposure to a large concentration of a single corporate obligor, or to a geographical location would increase the risks related to ESG factors. This step is usually managed through negative screening to remove the unwanted sectors of activity.

ESG exposure to the securitization trust

A securitized trust's exposure to governance risk lies with the trustee's transparency and experience. Weaknesses could become apparent when loan performance is poor, and the deal's structure is ambiguous.



Sources: LBS, BBH

Authorities dictating the pace of developments

United Nations PRI

The Principles for Responsible Investing, an international organisation dedicated to the stewardship and promotion of the United Nations' ambitions, has provided insight on the state of the market regarding the incorporation of ESG principles in securitised products (the "PRI Report"). It focuses in particular on the CLO initiatives, with highlights of the successes and the hurdles.

The first recognized CLO to include ESG principles in its documentation (Providus CLO I) launched in April of 2018. The pace of ESG CLO issuance has increased in 2019 and 2020, but is nowhere near the ascent in the bond market.

EU's Sustainable Finance Disclosure Regulation

The European Union's SFDR permits investors to be badged with an official stamp highlighting their alignment as either "promoting environmental or social characteristics" (article 8) or "having sustainable investment as its objective" (article 9). Such regulation impacts CLOs from the investor demand angle as it prevents the most ESG-compliant ones from participating unless the product has an approved SFDR seal.

Further developments on the investor side has persuaded CLO managers to provide a statement on whether they take into account the principal adverse impacts of their investment decisions on sustainability factors (SFDR article 4). The stated intention from the European Commissions is that CLO obligors will comply voluntarily to the ESG norms as the buyers of the products are subject to the regulations.

SEC investor advisory committee relating to ESG

On May 14, 2020, the SEC Investor Advisory Committee Relating to ESG had taken a first step by acknowledging that "despite a plethora of data, there is a lack of material, comparable, consistent information available upon which to base some of these decisions".

The SEC denotes that the vast array of third-party data providers that were active in the industry (over 125 as of 2016), the inconsistency in the selected criteria, and the resultant burden on corporate issuers may create confusion as the market evolves.

Late in March 2022, the SEC came back with plans to finalize the corporate disclosures surrounding carbon emissions, keeping close alignment with the Task Force on Climate-Related Financial Disclosures. The ruleset is expected to be finalized this year, with implementation for Scope 1 & 2 to start with 2023 filings for large accelerated filers, with Scope 3 added by 2024.

Sources: https://www.matheson.com/insights/detail/esg-clos-the-opportunities-and-challenges
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https://www.unpri.org/fixed-income/esg-incorporation-in-securitised-products-the-challenges-ahead/7462.article
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https://www.milbank.com/images/content/1/6/v4/167053/Updated-ESG-and-Euro-CLOs-The-Past-Present-and-Future.pdf

Future state of ESG in securitization

The securitization market is known for its innovative features and could therefore become a pivotal space for the debt markets in the transition towards net zero. In this phase of ESG discovery through bonds and loans, both issuers and investors are getting geared up with frameworks that will massively impact the next decade of the capital markets.

Despite the potential of securitized products in the sustainable markets, the size of issuances is lagging other ESG instruments. While this is probably due to the lack of clear and direct guidelines for what constitutes a sustainable CLO or MBS, there are multiple versions of securitization products that already align with the UN's SDGs or prepare for a transition to net-zero emissions. The popularity of such products may have to start with the acceptance of what is known as "ESG Proceeds Securitization", through which some non-ESG loans are pooled and sold in order to raise funds for future ESG loans. This 2-step approach is a possible path for securitization to transition rapidly.

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Sources: https://www.jdsupra.com/legalnews/talking-about-a-revolution-making-esg-7934236/

Appendix I — Case Study of Kensington Mortgage Company (UK) for complex revenues clientele (GMG 2021-1)

Framework

Written as per ICMA's social bond principles, in an attempt to contribute to UN SDG 10 "Reduced Inequalities". Second-Party Opinion provided by ISS ESG.

Structure

Each of the 7 tranches of this £505mm issuance are backed by a segregated pool of home loans and are issued by the SPV Gemgarto. The net proceeds of each Social Bond sold to investors will be applied to finance the Issuer's purchase of portfolios of loans originated by Kensington, as well as paying certain expenses incurred during the securitization and issuance processes.

Eligible Projects

The eligible projects under the securitization program aim to facilitate access to home loan finance for an underserved population made up of applicants with complex income situations. Some examples of such income sources are overtime hours, up to 100% of second job income, income from part-time work, bonus payments, certain allowances and benefits, child benefit payments, and pension incomes.

Most frequent cases where the traditional mortgages lenders' automated scoring processes would refuse a high quality profile are the self-employed, first-time buyers with limited credit history, contractors and later life or younger borrowers.

Exclusions

The following activities are not eligible under the Social Bond framework : weapons, gambling, tobacco, predatory lending, fossil fuel production

Only loans of a maximum of £2mm to owner-occupied residential properties are eligible for the securitization program.

Sources: https://investors.kensingtonmortgages.co.uk/esg
https://www.issgovernance.com/file/spo/spo-20210125-kensington.pdf

Appendix II — North Westerly VI CLO

Framework

This CLO was the first to consider ESG factors across all its investments and is therefore the first-ever CLO compliant with best practices of ESG-focused investing.

The CLO raises the bar for ESG standards in the leveraged credit market, with an absolute ban on companies involved in a variety of problematic industries, irrespective of the proportion of their earnings the comes from the activity in question. It has also committed to ESG scoring through the trustee reports, so buyers of the CLO debt can monitor the portfolio's ethics down the road.

Structure

The deal is structured in such a way that the loans selected have to go through both negative and positive screening. The negative screening portion aims to remove sectors and high-risk controlling shareholders, while the positive screening provides an ESG score based on both the sector and the individual company.

Each asset's ESG profile has to go through a due-diligence process before its inclusion in the securitized asset and is then monitored continuously throughout its life, so that there is ongoing surveillance and re-assessment of the portfolio' ESG profile.

Exclusions

◊ Power generation (coal, nuclear, large scale hydro-electric)

◊ Military & Defense (development, manufacturing and supply of weapons and munitions)

◊ Mining & mineral trade (coal, uranium, diamonds, minerals in conflict zones)

◊ Extreme fossil fuels (polar projects, oil/tar sands, fracking, production/trade in conflict zones)

◊ Production or trade in prohibited and damaging chemicals / materials (PCBs, CFCs, halons, asbestos)

◊ Production of tobacco and similarly addictive substances

◊ Gambling (casinos, online gambling and platforms)

◊ Animal welfare (animal testing for consumer goods, fur trade, exotic animal trade, overfishing)

◊ Activities damaging biodiversity (deforestation)

◊ Anti-social publishing, pornography

Sources: https://www.nibc.com/about-nibc/newsroom/newsroom/nibc-s-north-westerly-vi-clo-has-been-awarded-structured-finance-and-securitisation-deal-of-the-year-by-the-international-financial-law-review/
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