



Building an ESG Framework for Structured Credit Investing

Tracy Chen, CFA, CAIA |

Current Status of ESG Development in the Structured Credit Market

ESG as a concept, while widely accepted in equity investing and growing in importance in sovereign and corporate bonds, also should not be novel to investors in structured credits. Around 2006 and 2007, mortgage originators who lacked “skin in the game” recklessly lent to unqualified borrowers. At the same time, the “originate-to-distribute” securitization model proliferated. These practices, which would be red flagged as governance issues today, tarnished the securitization market and triggered the global financial crisis. Since then, the regulatory scrutiny has tightened drastically, cleaning up much of the malfeasance. Originators are mandated to retain “skin in the game,” and capital requirements have been raised for banks. ESG is gaining more buy-in and adoption across structured credit investors. However, ESG integration in structured credit still lags corporate credit and equities, where there are readily available ESG ratings and scores provided by third-party vendors. Major credit rating agencies do not offer ESG ratings for structured credits but are simply reviewing the relevance of ESG factors in their credit ratings.

Ideally, we believe the structured credit investor community should agree on a standard ESG dataset that issuers need to disclose. This ESG dataset would request the disclosure of specific and quantifiable data points on which to calibrate ESG factors. This consistent dataset would serve as a building block for developing the standardized framework for ESG analysis. Lack of standardized data disclosure and transparency is the primary challenge for ESG analysis for the structured credit investor community. As a result, each investor may have a different approach that incorporates its own ESG criteria for investing in structured credit.

Europe is ahead of the U.S. on the ESG front with the reinforced EU Securitization Regulation and the establishment of the Simple Transparent Standardized (STS) securitization label. They enabled certain standardization of structures along with more loan-level data transparency. All these regulatory efforts will support the governance of the securitization process. U.S. investors can look to Europe for important lessons and best practices.

Our ESG Screening Framework and Criteria

ESG factors have been integral to our investment decision-making process and part of our analytical research process. Our goal is to formalize a robust framework of internal ESG ratings for different issuers, originators, servicers, and securities that can be incorporated in investment decisions. Assessing securities against this ESG framework requires additional due diligence and surveillance. Given the structural complexity of securitization, we utilize a two-step approach by first assessing the ESG quality of the corporate entities related to the issuance of the bond, mainly the originator and servicer, and then, more importantly, focusing on the assets that are being securitized.

In assessing the ESG quality of the issuing or servicing corporate entities, we leverage our internal corporate ESG screening tools, combined with MSCI ESG scores and Verisk Maplecroft risk assessments. However, data for

most small, private entities is not easy to locate. Instead, we need to engage with them directly through meetings and calls. Our ESG screening guidelines encompass broad criteria, including both positive and negative screening:

- **Environmental:** We assess how an originator or servicer deals with natural catastrophes, like hurricanes, earthquakes, wildfires, or flood risks. COVID-19 has raised the importance for servicers to properly serve borrowers. We question servicers about their policies and practices that reflect their social responsibilities. We engage with companies' management teams to encourage environmentally friendly and socially responsible behaviors. We also favor deals with a certain percentage of green assets within the pool.
 - **Positive Screening:** We favor assets such as loans to energy-efficient homes, home improvement loans for energy-saving purposes, car loans for alternative energy, loans to small and medium-sized enterprises (SMEs) involved in renewable energy, etc.
 - **Negative Screening:** We limit our exposure to loans involved in business lending involved in highly polluting energy sources, car loans for diesel cars, and loans for particularly energy inefficient homes. Geographic locations with low sea levels or other known environmental risks should also be a concern.
- **Social:** We focus on how a servicer deals with borrowers experiencing financial difficulty and how an originator serves underserved, low-income communities.
 - **Positive Screening:** We favor securitizations backed by social housing, loans backed by medical care homes and healthcare facilities, and SMEs involved in social support programs. We support the government-sponsored enterprise's (GSE) affordable housing lending program supporting first-time home buyers.
 - **Negative Screening:** We would not favor unaffordable lending or predatory lending, such as payday lending with high interest rates.
- **Governance:** We assess the underwriting integrity of originators by reviewing their underwriting standards through risk metrics like loan-to-value ratios and loan documentation types, such as full documentation, bank statements, and W-2 forms, etc. To better understand their ethical standards, we ask questions like the frequencies and dollar amounts of any legal settlements and fines in which the originator and servicer may have been involved. We also monitor whether there is SEC reporting and data reporting transparency.
 - **Positive Screening:** We assess available loan-level data and whether the deal structure is standardized. We would favor deals with better information disclosure standards, such as deals with detailed reporting of COVID-19 related forbearance, etc.
 - **Negative Screening:** We would not favor transactions for which issuers have avoided retaining "skin in the game." We closely scrutinize deals with a lack of documentation. New platform marketplace lenders, which have grown quickly in recent years, have not yet experienced a recession. Therefore, we closely monitor their lending practices.

Assessing ESG Factors at the Collateral Asset Level

Despite the importance of assessing the corporate entities, given the bankruptcy remoteness of securitization, ESG assessments should focus on each securitization deal on a standalone basis. Since the performance of a deal is directly dependent on the performance of the pool of assets, ESG attributes of assets are essential and pivotal. Therefore, ensuring the assets meet the ESG criteria is important in monitoring ongoing compliance with our ESG framework.

Below are examples of how we conduct ESG assessments on the collateral assets of four main structured credit sectors:

- **Residential Mortgage-Backed Securities (RMBS):**
 - **Environmental:** We factor the impact of climate change into our credit-risk transfer (CRT) investing, as catastrophic risk is embedded in CRT deals due to the levered nature of the deals. Natural disasters heighten the risk of defaults and loan modifications. We map the distribution of underlying assets in hurricane, flood, fire, and earthquake zones and the percentage of assets with related insurance coverage.

- **Social:** Securities that help finance first-time homebuyers and owner-occupied starter homes rather than investor homes are favored in our ESG criteria. We aim to map distribution of assets in low income communities. Smaller-sized loans for low credit score borrowers and lending to underserved communities are also favored in our ESG screening.
- **Governance:** We assess the underwriting integrity of the originators by examining loan-to-value ratios, debt-to-income ratios, and mortgage loan documentation types, etc. We scrutinize predatory lending practices and lenders who "churn" borrowers.
- **Commercial Asset-Backed Securities (ABS):**
 - **Environmental:** Environmentally responsible lending criteria also apply to auto lending. Green and alternative energy, emission control, and fuel efficiency are key factors. Property Assessed Clean Energy (PACE) programs that encourage borrowers to save energy usage and solar ABS are favored in our ESG framework.
 - **Social:** We assess the types of borrowers and communities served with affordability and those that promote credit access as a mission.
 - **Governance:** Underwriting integrity of originators is critical. We analyze regulations on lending practices and compliance by lenders. Whether loan documents in consumer lending are transparent and straightforward are also factors to consider.
- **Commercial Mortgage-Backed Securities (CMBS):**
 - **Environmental:** A lion's share of the agency CMBS market has been oriented toward environmental protection within multifamily lending. Fannie Mae and Freddie Mac utilize their green-lending quotas mostly by incentivizing borrowers to improve their multifamily properties through enhancing water and energy usage efficiency. We also favor deals backed by commercial office buildings that are designed to be energy efficient buildings.
 - **Social:** The green-lending programs also have social benefits. Green-lending programs help increase the supply of affordable multifamily housing alternatives as single-family housing becomes less affordable.
 - **Governance:** Ensuring the underwriting integrity of the originator is primary. We closely monitor how special servicers handle forbearance, payment advancing, and loan modifications. We also assess sponsors' handling of their portfolios of distressed assets, which can have a significant impact on the performance of lower tranches of CMBS deals.
- **Collateralized Loan Obligations (CLO):**
 - **Environmental:** We favor green assets in underlying collateral and look out for loans in highly polluting sectors like coal mines, etc.
 - **Social:** We identify how CLO managers align their investment of underlying loans with considerations of social benefits to underserved SMEs in sectors encouraged by ESG requirements. We will screen for sectors that are controversial on the ESG front, like tobacco, etc.
 - **Governance:** We need to assess the asset stewardship of CLO managers. We inquire whether CLO managers incorporate ESG factors in their investment process and deal documents. We will examine how they strive to build par, select and trade underlying leveraged loans, and align the interest of various investors up and down the capital structure. We also monitor how they comply with the collateral eligibility and deal risk guidelines.

Conclusion

Adoption of ESG in structured credit has been lagging that of corporate bonds, sovereign bonds, and equities primarily due to the lack of a third-party ESG scoring system and standardized industry framework for assessment and data disclosure. We have built and are continuing to refine our own framework for ESG screening that is incorporated into our structured credit investment process. It is a two-step approach with due diligence on relevant entities (originators and servicers) combined with a focus on underlying collateral assets. The process includes both positive and negative screening. While these efforts are a work in progress, we will continue to engage with industry peers to advance ESG integration in structured credit investing on a broader,

standardized basis.

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