ESG integration in asset-backed securities

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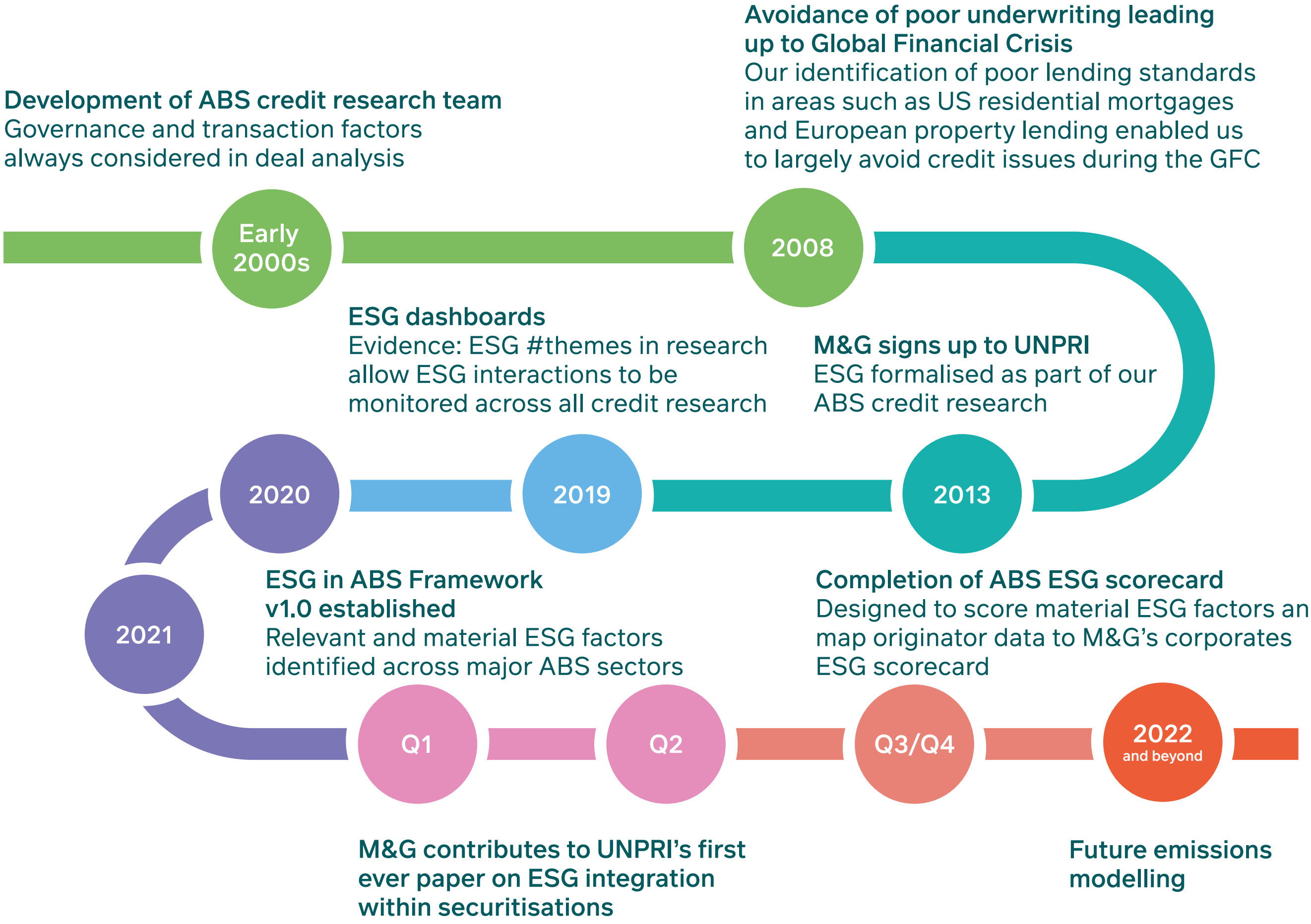
- Investors are adopting increasingly sophisticated approaches to ESG analysis; however, the industry lacks a consistent methodology for evaluating asset-backed securities (ABS). This is evidenced by an absence of third-party scoring systems from ESG ratings providers.
- As one of Europe's leading ABS investors, we are looking to play a major role in improving and standardising ESG practices.
- While ESG considerations have always formed part of our investment process, we have made significant progress in developing a more advanced ESG framework and extending our due diligence to provide more detailed quantitative analysis.
- Over the past two years, this has included developing proprietary research tools; implementing an ESG scorecard to standardise comparisons of ABS transaction, asset and counterparty-related ('TAC') risks and opportunities; and engaging with sponsors to enhance data provision.
- Our successful engagement with sponsors has already led to the wider adoption of certain practices, such as greater sharing of detailed UK mortgage payments holiday data in 2020 and improved carbon impact data on auto loans vehicle collateral.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

James King
Head of ABS portfolio management, M&G

Anuj Babber
Head of ABS credit research, M&G

Our ESG approach continues to evolve



Environmental, social and governance (ESG) investment analysis has rapidly transformed over recent years, as investors and regulators have recognised the importance of these considerations for generating potential, sustainable, long-term investment returns. Within traditional asset classes, this has led to a proliferation of third-party research from ratings providers, such as MSCI and Sustainalytics, which apply standardised, quantitatively driven ESG scoring systems to hundreds of thousands of securities. Regulators have also begun to implement formalised and far-reaching ESG policies, such as the European Union's Sustainable Finance Action Plan (SFAP), while in the UK, the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) is expected to significantly increase ESG-related requirements for investors.

In non-traditional asset classes, however, the development of standardised frameworks around both qualitative and quantitative considerations has proven more challenging due to the additional complexity of the securities involved. This includes asset-backed securities (ABS), for which third-party ESG ratings providers offer very limited coverage and regulators offer no specific guidance, despite this being a public asset class with over €400 billion of issuance outstanding in Europe alone.

We believe this places a strong emphasis on asset managers, such as M&G, which is one of the largest investors in European ABS, to drive the industry forward in improving and standardising ESG analysis in non-conventional areas of fixed income.

Our ESG journey stretches back more than two decades to the founding of our in-house ABS credit research team. Historically, much of our ESG approach focused on qualitative considerations and exclusion-based criteria. For instance, we excluded certain types of transactions from our investment universe where we identified predatory lending practices among originators or poor governance standards from sponsors. In the early 2000s, leading up to the global financial crisis, we were able to identify poor lending practices in US residential and European property, which enabled us to largely avoid credit issues during the subsequent market fallout.

Over the years, our ESG analysis has become increasingly rigorous, with a formal recognition of the need to incorporate an ESG lens into a holistic credit investment process. Applying this to ABS has been supported by our ability to leverage the development of M&G's wider ESG credit research capabilities in the corporate arena. However, whereas third-party ESG ratings providers typically base their methodologies on data processing and algorithms, M&G's proprietary ESG portfolio analytics tools place a stronger emphasis on qualitative considerations, which we believe can capture vital information that is unattainable through purely quantitative approaches.

ESG is fully integrated into our ABS investment process, with our analysis beginning at the idea generation stage before focusing on three core strands, namely the transaction (deal structure), assets and counterparty (or 'TAC'), and concluding with evaluation of the deal's execution, as shown below. This analysis has formed the bedrock of our ABS ESG scorecard, which we describe in detail later in this document.

ESG integration case study

Rejecting a CMBS deal due to poor safety disclosure

Recently, we chose not to invest in a major UK CMBS transaction due to concerns around the fire safety of the cladding used on the underlying properties and poor disclosure from the sponsor on planned remediation.

Within the collateral pool, over half of the hotels were found to be potentially non-compliant with fire safety regulations. The estimated cost of work to bring the properties in line with current standards was significant and involved a multi-year time frame. We requested further details of the costs, underlying assumptions, fire safety reports and project timelines, which the sponsor was unwilling to disclose.

We also found a lack of detail on these issues within valuation reports, as well as insufficient explanations around reduced occupancy due to other ongoing capex, which led to us decline participation in the transaction.

> **"We remain vigilant of predatory lending, and we do not invest in deals where we have identified this as a potential risk."**
>
> James King, head of ABS portfolio management, M&G

ESG considerations have been fully integrated into our investment process

Identify/ idea generation

Partnerships with issuers
- On-going dialogue with issuers
- Networking with potential counterparties
- Repeat transactions

Asset class
- General understanding
- M&G track record

Counterparty analysis

Business model of lending unit
- Underwriting criteria
- Distribution network
- Products, risk pricing

Counterparty ESG assessment
- Consultation with M&G's financial team on issuer's Governance controls

Servicing and work-out
- Procedures, policies, reporting lines
- Chinese walls with hedging team

Default risk
- Rating based triggers
- Account bank provider

Assets analysis

Past performance
- Originator's historical performance, including pre-crisis
- Effectiveness of servicing strategy

Collateral ESG assessment
- Consideration of environmental and social risks, eg carbon emissions of borrowers, flood risk and avoiding predatory lending
- Reducing exposure to sectors with excessive ESG risks, eg tobacco

Loan level analysis
- Evaluate risk layering
- Significant composition departures from lending book
- Leveraging M&G's expertise in each asset class

Transaction analysis

Structuring features
- Tranching
- Triggers
- Replenishment criteria
- Call optionality

Legal and governance analysis
- Jurisdiction constraints
- Tax issues
- Cash or Synthetic
- Regulation

Cashflow modelling
- Deterministic vs stochastic
- In-house modelling if required or Intex

Relative value/ execution

Pricing and sizing
- Pricing comps vs other markets
- Evaluate liquidity and buyer base

Allocation
- Senior management involvement if required
- Sponsor relationships
- Counterparty Management
- Leveraging M&G size

Decision to buy

Pass: Investments are applied across portfolios subject to return/risk profiles, and mandate guidelines

Position sizing will be a function of the portfolio managers' views on relative value

Fail: asset not purchased but PM team will continue to monitor relative value and analysts will follow fundamentals and ESG factors

Creating the M&G ABS ESG scorecard

ESG considerations have underpinned our investment process for many years; however, we have recognised the need for greater consistency and standardisation of comparisons between prospective transactions, as well as the potential benefits of improved quantitative analysis. We have also observed major developments in ESG integration within M&G, driven by the organisation's Stewardship & Sustainability team, which we felt could provide the foundations to build a more sophisticated ESG analysis framework.

Over recent years, we have therefore engaged closely with the M&G Stewardship & Sustainability team to build on the developments it has made in collaboration with investment teams across the organisation. Notably, from a credit research perspective, this has included helping to establish a consistent ESG framework for corporate bonds and loans. For public assets, this has involved creating dashboards underpinned by Sustainability Accounting Standards Board (SASB) materiality frameworks to provide structured data analysis and evidence of engagements. The team has also played a critical role in developing M&G's proprietary corporate ESG scorecard, which is shown below. These developments provided a crucial starting point for us to consider how to formalise a similar approach for ABS.

M&G's corporate ESG scorecard (sample considerations)

Below is a **small sample** of relevant and material ESG factors that form the basis of our proprietary corporate ESG scorecard.

Some of these factors are standardised, which means they are analysed for all companies, while others are sector-specific.

	Environmental	Social	Governance
Sample considerations	How much information does the company provide on its greenhouse gas emissions?	What steps are the company taking to minimise the risks of modern slavery across its supply chain?	What is the company's ownership and board structure? Is this aligned with industry best practice?
Sample considerations	How vulnerable are the company and its supply chain to climate change risks?	Does the company have comprehensive diversity and inclusion policies and practices?	Have there been any controversies at the firm? If so, how is the firm ensuring that appropriate action is taken and that such activities will not happen again?
Sample considerations	How does the company compare to its peers in moving towards a lower carbon future?		
	Environmental score	Social score	Governance score
	Overall ESG score		

While the M&G ESG corporate scorecard provided us with a strong template, directly mapping this type of ESG analysis onto ABS portfolios presented various challenges due to their fundamental differences with more conventional assets, such as corporate bonds. Whereas, traditional corporate bond analysis primarily involves evaluating the issuer and its capital structure, the securitisation process involves multiple entities, which can include:

- the originator;
- sponsor;
- servicer; and/or
- asset manager.

This introduces various complexities from an ESG perspective. For instance, rather than investing or lending directly to a specific company, an ABS transaction is likely to involve purchasing securities issued by a bankruptcy-remote special purpose vehicle (SPV), which has no board of directors or other employees. Meanwhile, the corporate entity that originated the assets may not be involved in the transaction, or the deal may be backed by loans originated by lenders that no longer exist.

Due to these fundamental differences, we believe ESG analysis of ABS requires careful evaluation of three core areas, which we have identified as transaction, asset and counterparty (or 'TAC') risks and opportunities. Based on this premise, we introduced a proprietary ABS ESG scorecard in 2021 to analyse both our existing portfolios and potential future transactions, which is shown below.

Transaction

Our ESG analysis looks at the design and structure of the transaction itself, which involves scrutinising the documentation provided. This will broadly define key aspects of the deal, such as cashflow waterfalls; triggers; calculations; counterparties; representations and warranties; default events; and investor quorums for voting on bondholder corporate actions. We will primarily look to determine whether the governance of the SPV is effective, with a view to mitigating potential credit and ESG issues.

Assets

As history has shown, it is essential to evaluate the quality of both the underlying loans and collateral in any ABS transaction. In a CMBS asset pool, for instance, we would perform an analysis of the mortgage loans and the underlying properties they are secured against. We may expect environmentally friendlier assets to outperform through a combination of operational efficiencies, their potential to command higher rents and more sustainable long-term valuations.

Counterparty

Counterparty evaluation is similar to ESG analysis of a corporate bond issuer. Our due diligence focuses on the underwriting and servicing practices of the originator or servicer, which we believe can provide a strong indication of the robustness of the underlying assets and collateral.

M&G's ABS ESG scorecard (sample considerations)

Below is a small sample of relevant and material ESG factors that form the basis of our proprietary ABS ESG scorecard.

Analysis of environmental, social and governance (ESG) factors

	Transaction	Assets	Counterparty
Sample considerations	Is the deal structured in line with the spirit of regulations or simply to the letter of the law?	Is there any indication of predatory lending within the asset pool?	How responsible are the originator's underwriting practices?
	Are appropriate governance features and controls in place?	How exposed are the assets to changing environmental conditions e.g. flood risk?	Is the servicer treating customers fairly? Is it empathetic to unexpected circumstances, such as Covid-19?
		How environmentally friendly are the assets in the collateral pool?	If originated by a corporate entity, what is our corporate analyst's view of the originator?
	Transaction score	Assets score	Counterparty score
	Overall ESG score		

ESG interactions and engagements

While the standardisation of securitisation processes and documentation has improved significantly over the past decade, the provision of ESG-related information is still inconsistent among sponsors and originators. We believe this underscores the importance of active engagement from asset managers to drive further progress in improving transparency across the industry.

Since the start of 2020, we have had around 30 engagements, alongside many further interactions, with issuers and arrangers, with the economic and social fallout of Covid-19 and the evident effects of climate change increasing the urgency to adopt new practices. We have broadly summarised some of our recent priorities within each of the 'Environmental', 'Social' and 'Governance' categories below:

1. **Environmental** We have primarily focused on obtaining greater environmental data disclosure, with an emphasis on CO_2 emissions estimates. We have had successful engagements with an increasing number of auto loan issuers and several RMBS issuers, which have begun to provide this data. Within CMBS, we have encouraged sponsors to provide more specific details on their ESG policies and capex schedules for improving energy efficiency in existing developments.
2. **Social** We have worked closely with UK RMBS issuers to understand trends in mortgage payment deferrals ('payment holidays') and how vulnerable customers are treated. We also engaged with issuers and arrangers to create new structural transaction features that were subsequently adopted by the wider market, notably payment holiday reserve funds, to mitigate concerns for bond holders in UK RMBS transactions. This structural feature was key to restarting the UK RMBS market in the summer of 2020.
3. **Governance** We have incorporated the ESG work performed by our corporate and financials credit team into the ABS ESG counterparty leg of our analysis. We have also engaged with issuers to ensure a smooth transition from LIBOR to SONIA as the new reference rate for UK transactions.

The securitisation industry is still in its infancy in providing ESG transparency and disclosure. However, by sharing our framework, we can better engage with issuers to obtain more relevant and standardised information. We recognise that there is still much work to do, and we recognise our responsibility to encourage improved market standards around ESG disclosure. We are therefore not only initiating bilateral conversations as part of prospective transactions, but also working with industry trade bodies to encourage better outcomes for the industry as a whole.

In the case studies below, we demonstrate our approach to interactions and engagements in specific recent transactions.

ESG integration case study

Recommending new deal structures and improving data transparency in UK RMBS

As part of the UK's response to the Covid-19 pandemic, the Financial Conduct Authority announced a series of moratoria to enable vulnerable consumers to defer due payments on their debts, including mortgage, auto and consumer loans, with a view to supporting household finances.

Given the unprecedented nature of the crisis, lenders were required to authorise borrowers' deferral requests without conducting extensive checks and balances. Our ABS credit research team worked with lenders and servicers to obtain data on the proportion of underlying loans within RMBS pools that were subject to payment holidays, with systems and communication frameworks evolving to distinguish those borrowers that had strategically accessed the scheme – in other words, those who could afford to resume payments – from those with the greatest need. We established that take-up was highest for those on lower incomes and the self-employed, particularly those exposed to the hospitality and retail sectors. Obtaining this data allowed us to closely observe trends, with payment deferrals falling significantly after July 2020.

In addition, we actively engaged with arrangers and issuers to introduce innovative new features into transaction structures with a view to restarting the RMBS new issuance market in June 2020, following several months of effective market closure since the Covid-19 crisis had taken hold in Europe. Our suggestion to include a new 'payment holiday reserve' in the transaction to mitigate liquidity concerns stemming from payment deferrals was widely adopted by UK RMBS issuers and welcomed by other investors in this period of uncertainty.

> **"Our suggestion to include an innovative new reserve fund in the transaction to mitigate liquidity concerns stemming from payment holidays was widely adopted by UK RMBS issuers in 2020."**
>
> Anuj Babber, head of ABS credit research, M&G

ESG integration case study

CLO questionnaires

Within the European collateralised loan obligation (CLO) market, we have begun to interact more closely with issuers by requesting them to complete M&G's proprietary CLO ESG questionnaire, with a view to encouraging the consideration of ESG factors in constructing and managing deals. This is now distributed as standard practice to all primary issuers, and their responses form part of our credit research write-up, as well as being fed into our scorecard. The responses may prompt us to interact or engage with a CLO manager should we identify a particular area of concern. We continue to observe a greater number of CLO managers incorporating a negative screening or minimum ESG scoring approach. This is a very positive development for the sector, and we continue to look favourably on managers who can clearly evidence their ESG credentials.

M&G's CLO ESG questionnaire – sample questions

ESG category	Sample question
Environmental	Does your organisation have environmental targets? Do you have plans to reduce carbon emissions? If so, what are these?
Environmental	Do you record which borrowers provide environmental factor disclosures? If so, what data do you gather relating to environmental factors of your borrowers (eg footprint, environmental regulation), and what can you share with CLO investors?
Social	Do you have social inclusion and workplace diversity corporate policies in place?
Social	Does your investment framework include any exclusions on the basis of negative social impacts? Have you declined or exited any investments based on social factors? If so, please can you provide three examples?
Governance	Do you hold any investments that your current ESG policy would prevent you from adding today?
Governance	Do you actively engage with sponsors or borrowers to try to improve ESG factors? If so, please can you provide three examples?
Governance	How is your CLO risk retention funded? Please give details of the split between internal vs. investor-funded contributions.

ESG integration case study

Encouraging better ESG data disclosure from UK RMBS originators

As a major presence in the UK RMBS market, M&G occasionally enters transactions on a bilateral basis following extensive periods of negotiation. A significant amount of associated discussions involve setting expectations on future ESG policy and data provision with the sponsor and originator.

In October 2021, we were pleased to see that an originator we have previously worked closely with – a UK challenger bank – had significantly increased its ESG disclosure upon bringing its latest RMBS deal to market. Notably, the bank had disclosed information on how its lending practices and day-to-day operations were aligned with the 17 United Nations Sustainable Development Goals (UN SDGs), alongside details of its own carbon footprint, staff diversity and measures it takes to avoid predatory lending. This was a welcome, major step forward.

We are encouraged by this high level of progress, and we will continue to work with the bank and broader sector to improve ESG data provision.

Using big data and technology to generate carbon emission estimates for ABS

As referenced in our recent paper, 'The next phase for private credit markets', obligations to report climate data in line with Task Force on Climate-Related Financial Disclosures (TCFD) are coming for asset owners and asset managers alike. For an asset class such as ABS, where the disclosure of environmental data has always been optional for originators, rather than mandatory, this has led to a dearth of high-quality carbon emission and intensity estimates. Therefore, we have continued to enhance our in-house 'Carbonator' carbon emissions approximation tool to expand beyond leveraged loans (its original purpose) and begin to estimate the emissions of collateral pools with securitisations.

For example, in auto ABS, the Carbonator utilises machine learning techniques to look for patterns across publicly available data input, including the car model, manufacturer, fuel type, year of registration and exhaust emission standard. Data may be sourced directly from underlying loan types where available, but also from sources such as the UK Vehicle Certification Agency. Assumptions will be used where no data is available. We can use this data to build carbon emission estimates for the pools and then share our analysis with auto ABS originators to engage and encourage them to provide their own in-depth carbon analysis of their new issue pools.

Pleasingly, we have seen an increase in auto ABS issuers, particularly newer lenders, disclosing pool emissions estimates in new-issue presentations. Meanwhile, some of the more established originators have shown an increasing willingness to provide their own high-level carbon metrics to allow us to refine our own emissions modelling tool. We hope this greater transparency will be a first step towards working to reduce carbon emissions across the sector.

Our emissions modelling has extended to CLOs, where we have built on the substantial work of our leveraged loans team to better understand the carbon emissions, environmental opportunities and threats within the underlying loan pools. Key inputs include the private company's size, sector and geography. Our next area of focus is RMBS, where geographical data, combined with information about property types, will be used as inputs alongside other factors. Naturally, we hope to use this information as a starting point for further engagement with originators on environmental data disclosure.

Helping to shape the industry and evolve our ESG capabilities

We have come a long way on our ESG journey since we began investing in European ABS at the turn of the century. Securitisations have undergone fundamental changes, which we believe have enhanced the protections provided to investors and disincentivised many of the poor lending practices that have previously affected borrowers. Nevertheless, in recent years, the industry has not moved at the same pace as others, notably the corporate bond sector, to adopt more sophisticated ESG approaches.

Our focus in 2022 and beyond is therefore to continue driving ESG integration within our investment process, with an immediate focus on producing more advanced carbon modelling; incorporating data into our proprietary research systems; and refining the M&G ABS ESG scorecard. We believe the implementation of this scorecard in 2021 was a major milestone for improving the consistency of our ESG analysis, allowing for more standardised comparisons of key ESG considerations between the deals that we evaluate. It has not only enabled us to better understand the factors that could affect an investment, but has also highlighted where gaps currently exist in sponsors' provision of information and offered a framework for us to directly engage with them.

We believe the direction of travel is clear: investors will increasingly scrutinise ABS transactions and portfolios, as ESG integration continues to gather pace across asset classes. Given our major role in the European securitisation market, we believe this places a strong emphasis on us to drive the changes that investors will demand. In doing so, we believe this can provide us with a significant advantage in influencing positive developments within the industry and the potential to deliver sustainable returns over the long term. □

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