The Investment Podcast

M&G Investments

Episode 27: The Investment Podcast: What does good ESG in ABS look like?

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Speaker 2: This podcast is for investment professionals only.

Romil Patel: Hello, and welcome back to another instalment of *The Investment Podcast*, brought to you by M&G Investments. My name is Romil Patel and I'm thrilled to be joined today by M&G's Anuj Babber, Head of Structured and Private Asset Research and Cristina de Guzmán Esteban, an ABS Credit Analyst. Welcome to you both.

Anuj Babber: Thank you for having us.

Cristina de Guzmán Esteban: Hello. Thank you.

Romil: Well, today's topic is ESG in Asset Backed Securities, or ABS for short. The evolution and implementation of ESG across asset classes has not been homogenous and it resonates more so with corporate debt and equities when compared with specialised asset classes such as ABS. What has been observed in the marketplace is big companies developing good outputs for corporates and equities, but with less of a focus on ABS, investors have been left to devise their own strategies. With ESG and ABS still in its infancy that has left much room for interpretation. That brings us to the starting point of how and why does ESG and ABS differ to other asset classes?

Anuj: Thank you, Romil. It is probably worth describing what ABS is. ABS are asset backed securities, which are financial securities backed by income generating assets such as residential mortgage loans, credit card receivables, or leveraged loans. Securities are issued through a bankruptcy remote vehicle, which lacks a traditional corporate structure that one would traditionally be used to. For instance, it doesn't have a board of directors, it doesn't really have a business strategy, but instead the SPV [Special Purpose Vehicle] is governed by a set of prospectus documentation for the life of the transaction and it dictates its operation during that period.

Now, given the nuanced structure that I just explained of a securitisation transaction versus a simple corporate, the ESG analysis is at the infancy when compared to more mature corporate and equity sectors. These sectors – the corporate and equity sectors – have rich third-party providers such as MSCI or Sustainalytics, and there's no real similar consensual ESG risk framework for the securitisation sector.

As you said, each investor has developed their proprietary framework, and at M&G we've developed our own framework as well through a scorecard, which measures ESG risks through three different lenses. We consider ESG metrics through the transaction design and structure, the assets being financed and lastly, the main counterparty to the transaction – be that the originator, the servicer, or the asset manager. The scorecard itself consists of 12 core ESG factors across all the different industry sectors that securitisation or ABS covers, which are then supplemented by more bespoke factors to capture the additional material risks for a particular asset class.

Romil: That leads us to differentiation, Anuj. How can we differentiate between ESG leaders and laggards within ABS, and what does good look like in ABS?

Anuj: When it comes to traditional ESG metrics, I guess one has to understand that on the whole, the European securitisation universe is a relatively clean universe. What I mean by that is that it has very little exposure to traditional sin sectors such as tobacco, oil and gas and gambling, or other similar sort of industries. These industries simply do not issue ABS transactions in the European space. When you go past that, you need to differentiate between transactions between those that are leaders and those that are laggards.

Now, our scorecard is purposely aspirational. It recognises that we're at the infancy of this journey and allows for future advancements. In that way, leaders and laggards will be a constantly fluid concept over time, identifying between those transactions that offer good relevant ESG metric disclosure backed by, for instance, green collateral, and those that have little intention of providing disclosure or simply those that are backed by assets that are not socially originated or serviced in compliance with local regulations or have negative environmental concerns.

Cristina: Yes, I agree, Anuj. If I could come in here, a simple example will be an auto ABS pool backed by all electric vehicles, which could be deemed a leader in today's market versus one back solidly by second-hand older diesel cars, which will be considered as a relative laggard. Also laggards can improve over time as we have mentioned before, through positive intent, engagement and better disclosure.

Romil: A clean universe indeed, Anuj, but ABS is also a broad universe. Cristina, is there much differentiation between ESG integration across sectors and what does engagement in ABS look like?

Cristina: Yes, indeed, there's a lot of differentiation between the integration across sectors and securitisation as the asset types are quite diverse and also the asset disclosure is very different across them. For example, on CLOs [Collateralised Loan Obligations] which are backed by leverage loans, we can consider a good CLO, for example, to be one that has started to report carbon emissions or other ESG data points. It will also include extensive ESG exclusion criteria through the prospectus and, for example, could have strong controls in the documentation which requires consent of multiple noteholders to modify or amend in important covenants in the transaction pricing.

Still, in this specific sector in CLOs, we still need to define what an ESG or green CLO means. However, for example, on RMBS [Residential Mortgage-Backed Security] this definition is quite different. RMBS are backed by residential mortgages and a good RMBS here could be a transaction backed by energy-efficient houses or one that discloses EPCs [Energy Performance Certificates]. We have seen this in UK back to late deals or RMBS from the Netherlands. You can see that it is very different when we are looking at the assets and the transactions and therefore that's why we have the best spot factors that Anuj mentioned before on the scorecard.

However, when we look at the counterparty although it could be a different counterparty, it could be a servicer, originator, or asset manager, the approach here is slightly more similar. We look to see if that counterparty has a strong investment or underwriting ESG framework, we consider whether they have set carbon emission targets at the company level as this could translate into better underwriting on those assets that are being securitised. Innovation, we will consider other factors as cyber security, diversity and inclusion, etc. As you can see, it's quite different between sectors.

Anuj: Cristina, if I can add, we've spent a lot of time developing and calibrating our ESG scorecard framework over the last couple of years for the outputs to be as comparable as possible but we recognise that there are going to be small differences at the edges between different sectors and different asset classes.

Romil: What's your experience of engaging with issuers in this asset class been like?

Cristina: From my experience, the engagement with issuers had been relatively positive. At M&G we follow the PRI [Principles for Responsible Investment] definition of engagement, which is interactions between an investor and the investee conducted with the purpose of improving an ESG issue or disclosure. But it needs to have a specific objective, action and outcome, which needs to be measurable and tracked. To give you an example of what an engagement is, last year we engaged with a sponsor on a CMBS [Commercial Mortgage-Backed Security] transaction.

CMBS is an asset backed security collateralised by commercial mortgages.

In this specific transaction, the proceeds were used to refinance energy-efficient warehousing assets. We engaged with the sponsor to obtain better disclosure of emissions and other environmental factors affected by diversion of these assets. We managed to get better disclosure so this was a successful engagement for us.

Romil: More broadly, Cristina, how is the securitisation industry coming together to support the development of ESG?

Cristina: There is a lack of a specific legal framework in the market. Market participants such as investors, issuers, arrangers, we are all working together to come up with voluntary framework to guide the markets towards a higher level of ESG standards, how to report data, etc. One example is ICMA, which is the International Capital Market Association, who has published a voluntary set of principles for green, social and sustainability bonds that also covers securitisations. In addition, we collaborate with AFME, which is the Association for Financial Markets in Europe and ELFA, which is the European Leveraged Finance Association.

An example of this collaboration – I am part of the CLO Investor committee at ELFA, and we have recently launched a CLO Manager ESG questionnaire. We put that together between different investors and we also presented this to the issuers before launching it broadly to the market. This includes a set of questions about ESG at a transaction, asset and counterparty level with the aim to have standardised data from different issuers. For the future, for example, we are focusing on data because data is key and to have standardised data is key to be able to compare different transactions.

We are putting together a data template to guide the managers on how to aggregate the data and have some set of principles so that the data is comparable.

Romil: Finally, to close the circle for today's episode, what does the future hold for ESG in ABS?

Cristina: Green and social issuance is still very low in Europe. We have seen an increase in issuance in the last couple of years coming mainly from green RMBS, which are residential mortgage-backed securities. The main leader is the Netherlands, but during the last two years, the UK market has now joined that list. However, European green securitisations still only accounts for 1.4% of the total green issuance in Europe, whereas this percentage is much higher in other countries such as China, which is 8%, or 32% in the US. As you can see, there is still a high potential for green securitisation to grow in Europe. We expect it to come from three different types of financing.

Firstly, from residential mortgage loans on energy efficient properties. Secondly, consumer lending for green home renovations. Thirdly, electric auto financing as Anuj mentioned before. However, the market still needs to define what green, social or ESG securitisation means for other sectors such as the CLOs, which are backed by leveraged loans. There's still a lot of work to do in the market and for investors to discuss and brainstorm.

Anuj: From my perspective, we need better standardised and relevant disclosure from issuers and that's particularly in relation to environmental data. As we mentioned before, the market is working towards this. Look, the obvious benefit in standardisation of data is that we can compare different transactions more effectively going forward.

However, in lieu of getting some of this environmental data, what we have developed in-house is a proprietary tool to estimate carbon emissions for the main asset classes such as RMBS, ABS and CLOs. We understand that this might not be 100% accurate, but we often use the outputs to engage with issuers to provide us with better information. Now, I believe securitisation will offer a very effective tool for financial institutions and businesses to transition to a more sustainable business model by supporting the origination of green assets and giving investors better access to sustainable investments in the future. Overall, I believe that the future is bright in the securitisation ESG sector.

Cristina: Yes, Anuj, and if I can add to that, the work that's been done by different working groups in AFME or ELFA is key to ensure consistency across the market and it will provide the consistency that other third-party data providers such as MSCI and Sustainalytics have done in other markets.

Romil: Unfortunately, that's all we have time for in today's instalment of *The Investment Podcast*. We hope you enjoyed today's show. It's been a pleasure speaking to you both, Anuj and Cristina, and thank you for sharing your insights.

Cristina: Thank you very much.

Anuj: Thank you for having me on the show, Romil.

Romil: Thank you to you, our audience, as always, for tuning in. We look forward to seeing you next time, but it's goodbye for now.

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