ESG considerations in securitised fixed income

At Thornburg, we feel a fully integrated investment approach is the most effective way to incorporate ESG factors into securitized fixed income analysis.

As environmental, social, and governance (ESG) investing continues to evolve in Europe, there are increasing questions among investors about how an ESG framework can be applied to securitised fixed income. The underlying loans backing the bonds in this space are generally U.S. based but have played an increasing role in the alpha and diversification targets of many global fixed-income programs. Historically, the development of ESG analysis has focused on equities and corporate bonds. The Sustainability Accounting Standards Board (SASB) conceptual framework, which identifies material factors for equity and corporate bond investors to consider when incorporating ESG into security research, does not exist for mortgage-backed issuers and most asset-backed issuers. As such, there is no agreed or standard approach to ESG investing in the securitised market. However, investors are coming to understand that ESG factors are material and relevant to security analysis, particularly for a space that is $12 trillion in total size.

ESG analysis in securitised – challenges and progress

There have been a number of historic challenges to implementing effective ESG analysis in the securitised market. Issuers provided little or no disclosure of ESG factors that could impact future cash flows. Indeed, most mortgage and asset-backed issuers were and are small, privately held companies that are not accustomed to providing these disclosures. They have had neither the requirements nor the demand from stakeholders to do so. The exception has been asset-backed issuers that also issue in the corporate market – for example, a large auto company with both secured and unsecured debt outstanding. Fortunately, investors are beginning to make issuers of all types more aware of the importance of ESG disclosures in analysis. Today, robust disclosures can attract a larger investor base that can lower the cost of capital for issuers, and ultimately, underlying borrowers.

Another challenge to ESG analysis is understanding the cash flow dynamics of hundreds or even thousands of underlying loans. Traditionally, the ESG corporate focus has centered around how management teams evaluate and manage ESG risks and opportunities. Securitised fixed income is unique in that idiosyncratic risk in individual loans is diversified away, necessitating a more holistic focus on how lending and underwriting standards, and broader social factors, impact security cash flow.

Fortunately, lending, and underwriting standards, particularly in the U.S. mortgage-backed securities market, improved meaningfully in the years since the global financial crisis. This effectively makes the space more ESG investor friendly. Prior to the global financial crisis, U.S. mortgage lenders were able to structure loans with features, such as negative amortisation, interest-only, or balloon payments that proved very harmful to borrowers, from both human and financial level perspectives. These practices were the main contributors to the foreclosure crisis that ensued beginning in 2007. The Dodd-Frank Act of 2010 passed in the United States made such lending practices unlawful, and in the non-agency lending space today, there are significantly more due diligence standards and protocols around assessing the borrower's ability to repay their obligations. Further, lending platforms currently exist that focus on historically underserved borrowers in a healthier way, using alternative but effective underwriting approaches with successful track records to assess borrowers' ability to repay.

Environmental

Though environmental considerations vary by sub-market, a common material factor is assessing how carbon emissions, and further regulation/legislation to reduce emissions, impact cash flow. For example, in auto ABS, we assess potential recovery values (in case of default) of gas vehicles given the trend toward higher fuel efficiency and the expected increased market share of electric vehicles.

ESG materiality: security sector types vs factors

Materiality Level: High; High/Medium; Medium/Low; Low

SECURITY TYPE	FACTORS															
	ENVIRONMENTAL						SOCIAL						GOVERNANCE			
	Emissions	Product Age	Energy Management	Water Management	Ecological Impacts	Geographic Concentration	Human Rights	Customer Privacy	Data Security	Access and Affordability	Customer Welfare	Lending Practices	Business Ethics	Competitive Behavior	Legal & Regulatory	Risk Management
Auto	High	High	High	Low	High/Medium	Medium/Low	Low	Low	Low	High/Medium	High/Medium	High	High	High	High	High/Medium
Aircraft	High/Medium	High/Medium	Medium/Low	Low	Medium/Low	Low	Low	Low	Low	Low	Medium/Low	Low	High/Medium	High/Medium	High	High/Medium
Consumer Loan	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Medium/Low	High	High	High/Medium	Medium/Low	Medium/Low
Container	Low	Low	High/Medium	Low	High/Medium	Low	High	Low	Low	Low	Low	High/Medium	High	High/Medium	High	High/Medium
Credit Card	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High/Medium	Medium/Low	Medium/Low
Equipment	High/Medium	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High	High	High
Timeshare	Low	High	High/Medium	High/Medium	Medium/Low	Medium/Low	Low	Medium/Low	Medium/Low	Medium/Low	Medium/Low	High	High	High	High/Medium	Medium/Low
Tower	Low	Low	Low	Low	Medium/Low	Medium/Low	Low	Low	Low	Low	Low	Low	High/Medium	High/Medium	Low	High/Medium
Railcar	Low	Low	Medium/Low	Low	Medium/Low	Low	Low	Low	Low	Low	Low	Low	High/Medium	High/Medium	High	Medium/Low
Rental Car	Medium/Low	High	Low	Low	High/Medium	Medium/Low	Low	Medium/Low	Medium/Low	Medium/Low	Medium/Low	High	High	High	High/Medium	Low
Solar	Low	Medium/Low	Medium/Low	Medium/Low	Low	Medium/Low	Low	Low	Low	Low	Medium/Low	Low	High/Medium	High	High	High/Medium
Student Loan	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High/Medium	Medium/Low	Medium/Low
Residential Mortgage	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High/Medium	Medium/Low	Medium/Low
CMBS	Low	Medium/Low	High	High	Medium/Low	Medium/Low	Low	Medium/Low	Medium/Low	High/Medium	Low	High	High	Medium/Low	High/Medium	High/Medium

Source: Thornburg.

Higher gas prices have a detrimental effect on collateral value, as electric vehicles become relatively more attractive in such an environment. Another example is within aircraft ABS, in which aircraft age is a material factor, not just for fuel efficiency but the likelihood that the vessel will be re-leased. Impact to disposition value presents risk as the transition to cleaner energy sources continues.

Energy and water management are closely associated with commercial properties, therefore impacting the analysis of commercial mortgage-backed securities (CMBS). Newer, energy-efficient buildings will be more desirable to tenants, given the reduced likelihood of costly upgrades necessary to comply with new regulations and building codes. This factor translates to favorable cash flow generation as well as higher property values.

Another material factor is heavy geographic concentration. Loan pools with large exposure to certain geographic areas may be exposed to climate events such as wildfires and hurricanes. Geographic concentration is disclosed on a deal-by-deal basis, and though a large geographical footprint is desirable, it is fairly common to see collateral concentration in one or two areas. Environmental risk is heightened if the collateral is focused in densely populated areas which can be significantly impacted by one large event.

Social

It can be reasonably argued that social factors have a direct impact, given the underlying loans in many sub-markets go to individual consumers. Therefore, the ability (or inability) to repay can have a meaningful effect on human lives. We believe research into material social factors lies in the analysis of the lending process itself. The goal is to understand issuers' underwriting processes for their effectiveness in assessing consumers' ability to repay. Loan structures that make repayment challenging may cause consumer credit impairment that can have financial reverberations for individuals for many years following a default. For an individual, account terms that are not clear and transparent may not be enforceable in court. This risk applies both to residential mortgage loans as well as consumer loans (i.e. home improvement) and credit card payments which flow through to asset-backed securities. Further, legal and litigation risk rises for issuers who engage in less robust underwriting processes, as well as for issuers who engage in aggressive collection practices or charge excessive late fees.

Asset-backed securities which derive cashflow on a corporate level have unique social considerations. For example, container ABS analysis includes due diligence into disclosures on practices that prevent illicit operations such as human or drug trafficking. For whole business securitisations, which typically include fast food business operations, an understanding of labor relations and wage policy can be material if not addressed at a franchisee or corporate level. The common thread is a potential business risk or legal/litigation risk and a subsequent determination of whether these factors are material enough to impact cash flow.

Governance

Governance factors are focused primarily on the issuer's lending and securitisation structure, operational considerations, and overall support and disclosure of ESG factors. Issuers with streamlined and centralised credit, funding and collections signal a strong underwriting platform and reduced risk of fraud. In a similar vein, poor securitisation reporting increases the risk of weak performance or fraud, which may not be detected quickly. We believe the best approach is to assess whether good governance exists on a deal level and if cash flows are distributed properly.

As mentioned, many issuers provide little or no ESG disclosure. We believe robust disclosure is important to our analysis and we continuously advocate for it with issuers during our due diligence meetings. Rich disclosure helps investors understand, among other factors, if an issuer has positive or ESG issues, to evaluate the sponsor management structure, and ultimately determine if there are material risks to the issuer's solvency.

Other relevant governance factors include business ethics, competitive behavior, legal and regulatory risks, and risk management practices. Governance factors often overlap with environmental and social factors – i.e., good governance itself actively identifies material environmental or social impacts and presumably leads to an effective plan of action.

Applying ESG factors to the securitised investment process

Although the securitised markets are driven by largely different fundamentals than the corporate sector, we believe the process for analysing ESG should be quite uniform. The way we apply ESG in the securitised sector follows the same foundation as all other ESG fixed income analysis. The evaluation must focus on financial materiality: determine material factors, understand their disclosures and ESG performance as part of the broader security analysis and use these material factors as part of the decision-making process to purchase or sell a security. We define material factors as those important to the issuer's financials and decision-making process, as judged by reasonable investors. The focus on material factors allows us confidence that ESG analysis incorporated into the investment process is robust and repeatable in a way that does not allow for greenwashing.

We engage with issuers on a frequent basis to obtain the information we feel is material to ESG analysis. We advocate with all issuers to provide as robust and detailed ESG disclosure as possible. The value we are trying to gain comes from pursuing an understanding of the issuer's process and practices. In fact, this is more important than what can be gleaned from quantitative data only. To the extent that an issuer may be unable or unwilling to share certain information, we assess whether the additional degree of uncertainty is reflected in the bond's pricing.

We believe in the importance of establishing and maintaining a propriety ESG securitised debt framework, rather than waiting for an industry standard to evolve. We utilise an integrated approach, i.e., a process centered around investment professionals conducting their own materiality analysis. Each investment team member executes on this ESG process. This integrated approach not only enhances our securitised research but also ensures a robust and consistent ESG process across the entire investing platform.

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